STATE OF INDIANA

INDIANA UTILITY REGULATORY COMMISSION

PETITION OF INDIANA-AMERICAN WATER COMPANY, INC. FOR AUTHORITY TO INCREASE ITS RATES AND CHARGES FOR WATER AND SEWER UTILITY SERVICE, FOR APPROVAL OF NEW SCHEDULES OF RATES AND CHARGES APPLICABLE THERETO, FOR APPROVAL OF CHANGES TO RULES AND REGULATIONS APPLICABLE TO SUCH SERVICE, AND FOR AUTHORIZATION TO DEFER IN A PENSION/OPEB BALANCING ACCOUNT OVER- AND UNDER-RECOVERIES FOR PASS THROUGH TO CUSTOMERS	)	CAUSE NO. 43680

PREFILED TESTIMONY

MAS REPORT 1

VOLUME IV

THE INDIANA OFFICE OF UTILITY CONSUMER COUNSELOR

OCTOBER 27, 2009

Respectfully Submitted by

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CERTIFICATE OF SERVICE

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Docket: A.08-01-024
Commissioner: John Bohn
Admin. Law Judge: Maribeth Bushey

Overland
Consulting

REGULATORY AUDIT OF 2006 AND 2007 GENERAL OFFICE EXPENSE AND TEST YEAR 2009 REVENUE REQUIREMENT OF CALIFORNIA AMERICAN WATER COMPANY

Prepared for the

CALIFORNIA PUBLIC UTILITIES COMMISSION
DIVISION OF RATEPAYER ADVOCATES

by

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SEPTEMBER 11, 2008

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Executive Summary

This report contains the findings of a regulatory audit by Overland Consulting (Overland) of California American Water Company's (CalAm's) 2009 forecasted test year General Office (GO) revenue requirement. CalAm is a subsidiary of American Water Works Company (American Water or AW). In addition to the test year revenue requirement, we also reviewed the allocation of common regulated and non-regulated costs from American Water's service companies to CalAm and CalAm's relationships with affiliated companies.

This report contains the following chapters:

1. Summary of CalAm's General Office Rate Filing and 2009 Test Year Revenue Requirement - Summarizes Overland's review of CalAm's GO expenses for 2006 and 2007, CalAm's test year 2009 rate filing and the test year revenue requirement.

2. Adjustments to CalAm's General Office Revenue Requirement - Summarizes Overland's recommended adjustments to CalAm's test year operations & maintenance expense.

3. National Service Company Allocations to CalAm - Summarizes, for each NSC rate filing category except customer service, the basis for CalAm's historical and test year NSC expenses and allocations, Overland's analysis, and Overland's test year recommendations. Recommendations relating to test year expense mirror those discussed in Chapter 2.

4. NSC Customer Service Center - Discusses customer service expense incurred by AW's two national call centers, growth in expenses charged to CalAm, CSC allocations to CalAm and CSC services provided under non-regulated contracts with municipalities. Includes related recommendations for test year expense, mirrored in Chapter 2.

5. Local Service Company and California Corporate Allocations to CalAm - Summarizes, for the LSC and Cal Corp, the basis for CalAm's historical and test year expenses, allocations to CalAm and Overland's analysis of LSC and Cal Corp.

6. RWE Acquisition and Spin-Off of Interest and Analysis of Synergy Savings from Citizens Acquisition - Addresses certain matters associated with Commission-imposed requirements from previous proceedings; namely:
   - Conditions imposed in D.02-12-068, authorizing the transfer of control of American Water to RWE.
   - Conditions imposed in D.07-05-031, authorizing the American Water IPO.
   - Conditions required by D.01-09-057, allowing recovery of an acquisition premium associated with the purchase of Citizens Utilities water assets in California.

   Chapter 6 also addresses ongoing requirements imposed by the Commission associated with: the CalAm acquisition of water assets previously owned by Citizens Utilities; specifically the analysis of synergy benefits imputed due to the operation of these properties by CalAm in relation to the acquisition premium allowed in rates to date.

Finally, potential implications of the recent sale of the Felton assets on the amount of acquisition premium recoverable from CalAm customers is addressed.

7. Rate Case Expense - Discusses CalAm's requested rate case expense associated with the current GRC cycle. Rate case expense is not part of the GO test year revenue requirement discussed above. DRA, rather than Overland, is making a recommendation concerning rate case expense recovery.

8. District Allocations of the General Office Revenue Requirement - Discusses Overland's recommended customer-based method and CalAm's proposed "four-factor" method for allocating the GO revenue requirement to California districts.

Summary of the General Office Revenue Requirement

The following table compares previously authorized, requested (by CalAm) and recommended (by Overland) test year GO revenue requirements. The components of this table are discussed in Chapter 1. The test year revenue requirement "per CalAm" calculation is based on our analysis of the rate filing. It does not appear, per se, in the rate filing.

Ta e ES 1
Ca fo aA e a ae
Co a o of P e o A o e Co a Re e e a O e a Re o e e
e e a Off e Te ea Re e e Re e e

Components of CalAm's General Office Revenue Requirement	Last Authorized (2006 Test Year)	Test Year 2009			
		Per CalAm		Per Overland (DRA)	
		Amount	Change from Authorized	Amount	Change from Authorized
O&M Expense Revenue Requirement	11,298,350	16,858,609	5,560,259	13,226,419	1,928,069
Rate Base Rev. Req. (1)	823,405	140,066	(683,339)	140,066	(683,339)
CalAm General Office Revenue Req.	12,121,755	16,998,675	4,876,920	13,366,485	1,244,730
Percentage Increase		-	40.23%	-	10.27%

Sources: CalAm numbers: Rate Filing Exhibit B, Ch. 1, Sec.3, Table 1 ; Overland numbers: Report Table 1-2 (Rate Base); Table 2-1 (Operating Expense).
(1) Last Authorized rate base rev. reqmt. is calculated using data provided by CalAm in Rate Filing Exh.B, Ch.1, Sec.3, Table 1. Overland does not have high confidence in this amount, but it is the only amount available. It does not appear to include either the C tizens acquis tion premium or the RWE merger synergy savings (for which approved amounts are shown in D.06-11-050, Att. 3)

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CalAm's and Overland's 2009 test year GO revenue requirements, as allocated to the district level, are shown below.[1] The components of this table are discussed in Chapter 8.

Ta e ES
Ca fo aA e a ae
Te ea 00 e e a Off e Re e e Re e e A o a o o O e a o
Ra e a e a O M E e e

CalAm District	Per CalAm		Per Overland		Overland Adjustment to CalAm
	4 Factor Pcts	Amount	Customer Pcts	Amount	
Coronado	10.80%	1,835,857	12.22%	1,633,384	(202,472)
Los Angeles	13.54%	2,301,621	16.30%	2,178,737	(122,884)
Village	13.39%	2,276,123	12.35%	1,650,761	(625,362)
Monterey Water	31.81%	5,407,279	23.55%	3,147,807	(2,259,471)
Monterey Wastewater	2.28%	387,570	1.32%	176,438	(211,132)
Felton	1.54%	261,780	0.00%	-	(261,780)
Sacramento	24.75%	4,207,172	32.88%	4,394,900	187,728
Larkfield	1.89%	321,275	1.38%	184,457	(136,817)
To a	**100.00**	**16 8 675**	**100.00**	**13 366 485**	**3 63 1 0**

Sources: Per CalAm: 4 Factor Pcts - CalAm Workpaper GO-100; Cal-Am Total Rev Req Amount - Table ES-1. Per Overland: Customer Allocation Factors - Table 8-1, Total 2008 & 2009 Revenue Requirements - Table ES-1; District-Allocated Amounts (Per CalAm and Per Overland) - Calculated from totals and factors.

Recommended Adjustments to CalAm's General Office Revenue Requirement (Chapter 2)

1. Adjustment to Annualize Labor to Reflect Actual Budget Year Staffing - Overland recommends limiting recovery of test year GO labor expense to compensation for employees on service company payrolls as of May 31, 2008. This reduces test year expense allocated to CalAm by $338,591 in 2008 and $380,171 in test year 2009 (Chapter 2, page 2).

2. Reduce Budgeted Employee Incentive Compensation - Overland recommends that GO incentive compensation be limited to amounts paid for 2007, adjusted for salary inflation, and limited to employees in salary bands for which CalAm provided requested incentive plan documents. This reduces GO expense allocated to CalAm by $589,158 in 2008 and $598,546 in test year 2009 (Chapter 2, page 4).

[1] As far as Overland can determine, CalAm's rate filing supports a 2009 GO revenue requirement calculation of $16,998,675 before district allocation, a Monterey-Toro-Chualar-Ambler Park-Ralph Lane allocated water revenue requirement of $5,407,279 and a Monterey wastewater revenue requirement of $387,570. This is calculated from Proposed Total GO O&M of $16,858,609 and Proposed Rate Base of $1,026,026 as shown in Rate Filing Exh.B, Ch.1, Sec.1.Table 1 (and also Ch.4, Sec.1, Table 1 for the O&M). A complete GO revenue requirement calculation does not appear anywhere in the rate filing. We cannot account for an apparently contradictory 2009 revenue requirement calculation of $15,677,624 on CalAm Workpaper GO-100, or the associated Monterey allocation (including smaller districts noted above) of $4,987,647, because it does not agree with the amount in the rate filing schedules in Exh.B, Chapters 1 and 4, and it is not referenced to anything.

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3. Remove Business Development Expense - Overland recommends no ratepayer funding of expenses allocated from NSC and LSC business development functions. This recommendation reduces GO expense allocated to CalAm by $371,469 in budget year 2008 and $383,185 in test year 2009 (Chapter 2, page 7).

4. Remove NSC Corporate Contributions Expense - Overland recommends removing charitable contribution and related expense allocated to CalAm by the NSC. This recommendation reduces GO expense allocated to CalAm by $20,623 in budget year 2008 and $20,623 in test year 2009 (Chapter 2, page 8).

5. Remove Legislative and Political Influence Expense - We recommend removing expenses incurred to influence legislation from CalAm's test year revenue requirement GO expense. Our recommended adjustment reduces GO expense allocated to CalAm by $211,004 in budget year 2008 and by $218,213 in the 2009 test year. (Chapter 2, page 9)

6. Remove Unsupported "NSC Functions" Expense - Overland recommends removing expenses in the"NSC Functions" rate filing category that do not meet regulatory standards required for ratepayer recovery. This recommendation reduces GO expense allocated to CalAm by $545,959 in budget year 2008 and $82,520 in test year 2009 (Chapter 2, page 10)

7. Correct NSC Income Tax Expense and Interest Income - We recommend adjustments to NSC-allocated income tax and interest income. The adjustments increase CalAm's GO expense by $38,195 in budget year 2008 and $38,195 in the 2009 test year (Chapter 2, page 11).

8. Remove NSC Sales and Marketing Expense - We recommend removing marketing and sales expenses incurred and allocated to CalAm from the NSC. This adjustment reduces CalAm's GO expense by $72,056 in budget year 2008 and in the 2009 test year. (Chapter 2, page 12)

9. Limit Customer Service Center (CSC) Expense to 2003 Expense Plus Inflation - We recommend limiting CalAm's CSC expense to $1,971,507 based on per-customer expense incurred in 2003, adjusted upward by for inflation. This reduces CalAm's GO expense by $831,111 in budget year 2008 and in the 2009 test year (Chapter 2, page 12).

10. Remove Unnecessary Payroll Reserve - Overland recommends an adjustment to remove a CalAm-allocated LSC payroll reserve for "bonus or promotional increase[s]." 2009 LSC expense allocated to CalAm already includes pay and benefit increases ranging from 3 to 5%, as well as incentive compensation. This reduces CalAm's GO expense by $30,050 in budget year 2008 and by $30,801 in the 2009 test year (Chapter 2, page 13).

Executive Summary

11. Correct Omission of Operating Risk Department Salaries - Overland recommends an adjustment to correct this error by adding back the expense. This adjustment increases CalAm's GO expense by $83,036 in test year 2009. The adjustment does not change budget year 2008 expense (Chapter 2, page 13).

12. Reverse Allocation Impact of Re-Branding LSC Employees as California-Only - Overland recommends that 12 of 17 employees reclassified in 2006 and 2007 from the LSC organization to the Cal Corp organization be allocated to the states served by the LSC as they were before they we re-branded as Cal Corp employees. This reduces CalAm's GO expense by $321,011 in budget year 2008 and by $334,197 the 2009 test year (Chapter 2, page 13).

13. Remove Cal Corp Labor Separately Requested in Rate Case Expense - CalAm has requested recovery of more than 100% of the labor costs of four Cal Corp employees in its filing. Overland recommends adjusting labor costs to correct this error. This adjustment reduces GO expense allocated to CalAm by $33,236 in budget year 2008 and $34,664 in the 2009 test year. (Chapter 2, page 14)

14. Correct Allocations to CalAm - Overland recommends adjustments to CalAm's proposed test year NSC and LSC allocation factors to properly reflect an allocation of test year NSC expenses to regulated and non-regulated segments and among the regulated utilities. The adjustments reduce CalAm's allocated GO expense by $765,157 in budget year 2008 and $767,334 in 2009 (Chapter 2, page 15).

Recommended Basis for District-Level GO Revenue Requirement Allocations (Chapter 8)

1. District Allocation - For ratemaking purposes, all national service company expenses and a majority of regional service company expense are allocated to the State of California jurisdictional level based on customers. We recommend the Commission require CalAm to use the same customer-based method for further allocation to the district level (Chapter 8, page 2).

Summary of Other Recommendations

1. Rate Filing and Workpaper Support - In future rate filings Overland recommends that the Commission require CalAm to organize rate filing and workpaper support in a hierarchical fashion, with summarized rate filing information rolling up from more detailed workpaper support, and with all workpapers and rate filing schedules properly numbered and referenced (Chapter 1, page 8).

2. Rate Base and Overall Revenue Requirement Calculations - We recommend for future rate filings that the Commission require CalAm to provide a calculation of its rate base, rate base revenue requirement and overall GO revenue requirement. (Chapter 1, page 9).

Executive Summary

3. Support for Expenses Allocated from the National and Local Service Companies - We recommend for future rate filings that the Commission require CalAm to provide supporting documentation in the filing for expenses allocated from both the National and Local Service Companies. (Chapter 1, page 9).

4. An Affidavit or a Statement in Testimony Confirming That Commission Requirements Have Been Met - To the extent the Commission adopts the recommendations above, we further recommend that the Commission require CalAm to include an affidavit in the rate filing or a statement by the appropriate witness that the specific rate filing support recommendations required by the Commission have been met (Chapter 1, page 9).

5. DRA Access to Non-Regulated and Affiliate Transactions Data - To the extent that it is not clear that DRA already has the right to review the financial and operating data of CalAm's affiliates, we recommend the Commission specifically require CalAm to make such information available in future rate and other proceedings in which affiliate transactions, cost allocations and related possible cross-subsidization are potential subjects or issues (Chapter 1, page 10).

6. Support for Cost Allocations to Non-Regulated Customer Services - With respect to non-regulated services provided by the Customer Service Center, to prevent CalAm from cross-subsidizing CSC services provided to non-regulated municipal customers, Overland recommends that the Commission require CalAm to credit all revenue from non-regulated CSC revenue sources against CSC management fees before the fees are distributed to CalAm (Chapter 4, page 10).

7. Conditions Relating to the Spinoff From RWE - CalAm has represented that its customers will benefit from the spin-off from RWE. However, given the substantial pressure imposed by a capital program that exceeds cash flows available from operations, and the significant goodwill that remains on the company's books, it appears evident that the recent downgradings by S&P and Moody's indicate an erosion in financial position; not an enhancement. Regulated utilities, in the face of such conditions, generally attempt to either raise customer rates, cut costs, or both. Overland assumes that, in imposing conditions reflected in previous decisions, the Commission did so as a basis to: evaluate the delivery of benefits represented by CalAm; and to assess and safeguard against potential harm to ratepayers. As such, the Commission may wish to consider the conditions described in Chapter 6, in the Findings and Conclusions section of the Transfer of Control discussion (Chapter 6, page 10).

8. Gain from the Sale of Felton - With regard to the gain from the sale of the Felton properties, we believe that the facts and circumstances associated with this transaction, in light of the acquisition premium in current CalAm rates that are potentially attributable to these properties, now warrants further Commission scrutiny. We believe that the gain on

these properties may be in the range of $5-6 million.[2] It is clear that the Commission reserves the right of review for the disposition of utility property; particularly in case-specific circumstances where its general policy may not apply. Given our previous discussion on this subject, it may be appropriate to reduce the current acquisition premium by the gain realized in the Felton transaction. However, without more detailed information, we cannot make any final recommendations at this time (Chapter 6, page 20).

[2] The Company has refused to produce specific information that would provide details regarding to actual gain on the Felton transaction. General market indicators support a market-to-book ratio of about 2x. However, actual transaction data may vary materially from this general assumption.

1. Summary of CalAm's General Office Rate Filing and 2009 Test Year Revenue Requirement

This chapter summarizes Overland's review of California American Water Company's (CalAm) General Office (GO) rate filing and revenue requirement. It includes a summary discussion of CalAm's revenue requirement, a discussion of the support for the revenue requirement CalAm provided in its rate filing, a discussion of non-regulated and affiliate transactions and problems Overland encountered in reviewing them, and recommendations relevant to these discussions.

Components of CalAm's General Office Revenue Requirement

The GO revenue requirement consists of the following components:

- National Service Company (NSC) Allocations - The NSC consists of corporate functions such as finance, treasury and planning and various shared services (accounting, human resources, customer service, information technology, procurement and water quality). NSC expense allocated to CalAm accounts for approximately one-half of CalAm's GO revenue requirement request.

- Local Service Company (LSC) Allocations - The LSC consists of American Water's (AW's) western region operations. Western Region expenses are allocated primarily between California and Arizona, which contain a majority of the region's customers. Smaller amounts are allocated to Texas, New Mexico and Hawaii.

- Charges from California Corporate (CalCorp) - The CalCorp unit contains operating expenses from former LSC employees who were previously allocated to multiple states in American Water's (AW's) Western Region, but who are charged entirely to California in CalAm's current rate filing. CalCorp also includes expenses of employees who have been hired to serve operations only in California. CalCorp expenses are charged entirely to CalAm.

Comparison of CalAm's Previously Authorized, CalAm's Proposed and Overland's Recommended Test Year General Office Revenue Requirements

The table below compares the summarized General Office revenue requirements: 1) as authorized in the previous General Rate Case proceeding; 2) test year 2009 as proposed by CalAm; and 3) test year 2009 as recommended by Overland. A comparison of CalAm's and Overland's recommended revenue requirements distributed to the district level is shown in Chapter 8, Table 8-2.

Chapter 1

Ta e I J Ca fo a A e a a e Co a o of P e o A o e Co a Re e e a O e a Re o e e e e a Off e Te ea Re e e Re e e					
Components of CalAm's General Office Revenue Requirement	Last Authorized (2006 Test Year)	Test Year 2009			
		Per CalAm		Per Overland (DRA)	
		Amount	Change from Authorized	Amount	Change from Authorized
O&M Expense Revenue Requirement	11,298,350	16,858,609	5,560,259	13,226,419	1,928,069
Rate Base Rev. Req. (1)	823,405	140,066	(683,339)	140,066	(683,339)
CalAm General Office Revenue Req.	12,121,755	16,998,675	4,876,920	13,366,485	1,244,730
Percentage Increase			40.23%		10.27%

Sources: CalAm numbers: Rate Filing Exhibit B, Ch. 1, Sec.3, Table 1 ; Overland numbers: Report Table 1-2 (Rate Base); Table 2-1 (Operating Expense). (1)
Last Authorized rate base rev. reqmt. is calculated using data provided by CalAm in Rate Filing Exh.B, Ch.1, Sec.3, Table 1. Overland does not have high confidence in this amount, but it is the only amount available. It does not appear to include either the Citizens acquisition premium or the RWE merger synergy savings (for which approved amounts are shown in D.06-11-050, Att. 3)

Operations and Maintenance Expense - Differences between the Overland and Company revenue requirements for test year 2009 are due entirely to Overland's recommended adjustments to CalAm's proposed General Office O&M expense. These adjustments are summarized and discussed in Chapter 2. The individual service company components of operations and maintenance expense are discussed in Chapters 3 and 4 (for the NSC) and Chapter 5 (for the LSC and CalCorp). The following table summarizes the General Office O&M revenue requirement by service company component.

Ta e I Ca fo a A e a a e e e a Off e O e a g Ma e a e E e e Re e e Re e e Se e Co a Co o e efo e a Af e A o a o o Ca A			
	Test Year 2009		
	Per CalAm	Per Overland (DRA)	Recommended Adjustment to CalAm
A o a e o Ca A			
National Service Company	154,529,094	126,987,350	(27,541,744)
Local Service Company	9,798,017	7,529,236	(2,268,781)
Cal Corp	4,954,495	4,251,268	(703,227)
To a	**16 81 606**	**138 6 854**	**30 513 5**
Af e A o a o o Ca A			
National Service Company	8,357,126	6,221,706	(2,135,420)
Local Service Company	3,546,988	3,099,132	(447,856)
Cal Corp	4,954,495	3,905,580	(1,048,915)
To a	**16 858 60**	**13 641**	**363 1 0**
Source: CalAm Rate Filing, Overland Report Chs. 2, 3, 4, 5			

Chapter 1

Rate Base - Rate base does not contribute significantly to the test year 2009 General Office revenue requirement. As far as Overland can determine, CalAm's rate filing does not include a direct calculation of the revenue requirement associated with rate base. As such, there is also no total revenue requirement (O&M, return and tax) calculation in the rate filing. Rate base amounts presented in CalAm's filing include the following:

Exhibit B, Chapter 1, Section 2, Table 1:
- Proposed Test Year 2009 Rate Base $1,269,864
- Proposed Year 2010 Rate Base $ 782,388

Exhibit B, Chapter 1, Section 3, Table 1:
- Proposed Costs $1,026,126

The second table (Section 3, Table 1) also contains information to permit a calculation of CalAm's intended rate base revenue requirement, including a rate of return of 7.8% and a net-to-gross (tax) multiplier of 1.75. The amount in the second table is the average of the two amounts in the first table. Overland used the second amount to calculate what we believe is CalAm's requested 2009 test year rate base revenue requirement, as shown in the table below. This calculation does not appear in the rate filing.

Ta e 1 3
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Ca a o of Ra e a e Re e e Re e e

Item	2009
Proposed Average Rate Base per Cal-Am	1,026,126
Rate of Return per Cal-Am	7.80%
Requested Return	80,038
Tax Multiplier	1.75
Rate Base Revenue Requirement	140,066

Source: Rate Base Amounts: General Office Rate Filing, Exhibit B, Chap 1, Section 3, Table 1

Primarily because rate base revenue requirement is so small (less than one percent of the total General Office revenue requirement per CalAm), we did not attempt to audit it.

Rate Filing Support for CalAm's General Office Revenue Requirement

We found CalAm's rate filing lacking in support for specific components of the GO revenue requirement.

- Lack of Tables Summarizing the General Office Revenue Requirement and Rate Base - As noted in the discussion of rate base above, CalAm's rate filing does not include an overall calculation of the test year General Office revenue requirement. It also does not include a calculation of the General Office rate base or the revenue requirement associated with rate base. With some effort it can be determined what CalAm probably intends these amounts to be, but they are not set forth directly in the filing.

- Support for NSC Expense - CalAm's rate filing contains virtually no support for the NSC portion of the General Office expenses, which, as noted above, accounts for about one-half of the total GO revenue requirement. The test year quantitative expense data for the NSC consists entirely of nine summarized test year-proposed O&M expense amounts (one for each of nine NSC rate filing categories). These nine amounts are repeated in several tables, but there is nothing in the filing, in the workpapers or in the accompanying testimony that discloses the business units, budgeted total expenditures, budgeted management fees, or the allocation factors from which CalAm's proposed test year NSC expense is derived.

- LSC and Cal Corp - Filed support for the LSC and Cal Corp allocations to CalAm is marginally better than for the NSC. While CalAm provided details of total costs incurred by each entity on an object account basis, amounts did not always agree from one exhibit to the next, the handful of filed workpapers lacked a discernible audit trail, and testimony did not provide insight into contentious issues. However, by the time that data requests were issued to CalAm on LSC and Cal Corp matters, many of the delays experienced in the NSC area had been "ironed out", and responses were generally, but not always, on point.

- Rate Filing Presentation Problems - In general, there is a lack of organization in the rate filing and workpapers. Depending on the schedule or workpaper, cross-referencing between the rate filing schedules and workpapers and within the workpapers is limited or non-existent. In many places it is difficult to determine the source for amounts in summarized schedules, and where the amounts in detailed schedules are summarized.

Discovery Problems

Data Supporting the NSC Component of the General Office Revenue Requirement - As noted above, the rate filing and accompanying CalAm workpapers contain virtually no support for NSC expenses that comprise about one-half of the GO revenue requirement. In addition to lack of support in the filing, CalAm and AW made it difficult to compile, through discovery, the NSC expense support included and discussed in this report. It took more than three months and several rounds of discovery to obtain the business-unit budget data on which test year NSC expense is based. Just determining how the NSC's business units correlated with the NSC categories in CalAm's rate filing required several rounds of data requests. We also encountered problems obtaining lists of NSC employees. On two different occasions (once early in the project and later in response to a followup request) CalAm determined that, somehow, it was in its interest to provide schedules of NSC employees and positions with the employee names removed.

Data Supporting Cost Allocations Between AW's Regulated and Non-Regulated Segments - We also encountered difficulties in obtaining information about the subsidiaries in AW's non-regulated business segment. As discussed below, the inability to obtain financial results for unregulated subsidiaries negatively affected our ability to evaluate affiliate relationships and the reasonableness of allocations of NSC expenses between regulated and non-regulated segments.

Discovery Related to Conditions Imposed by the Commission in Decisions Associated with the RWE's Acquisition of and Subsequent Divestiture of American Water - In the absence of compliance with Commission Orders in its application regarding conditions in the RWE acquisition and divestiture decisions, Overland attempted to illicit this information in formal discovery in initial and subsequent data requests. However, in spite of these requests, CalAm has maintained that it need not provide such information, as it represents that it has met its burden of proof concerning these Commission requirements. Overland strongly disagrees, and addresses these deficiencies in Chapter 6.

Discovery Related to the Sale of Felton - Upon learning of the sale of the Felton assets, Overland issued discovery to ascertain details about the transaction necessary to address potential ratemaking issues in the current proceedings. Aside from providing a copy of the settlement agreement, CalAm declined to provide the requested information.

Affiliate Transactions and Common Cost Allocations to the Non-Regulated Segment

The Settlement Agreement as to Certain Issues for General Office between the Office of Ratepayer Advocates and CalAm, dated October 13, 2005, states that "ORA will retain an outside audit firm to review the GO operations and its cost allocations to the various ratemaking districts." It further states that "[t]he scope of the audit will be to review if GO allocations to the districts are reasonable and properly allocated in accordance with applicable Commission decisions, rules and policies regarding cost allocations. Administrative and General expenses that were previously part of GO allocations will also be audited. In addition, a review of CAW's compliance with the Commission's affiliate transaction rules will be covered as part of the audit scope."

We found that there are significant interrelationships between AW's regulated and non-regulated businesses. To properly understand and assess the reasonableness of these relationships and the transactions and cost allocations between regulated and non-regulated subsidiaries, it is necessary to have a thorough understanding of the financial and operational aspects of a company's regulated and non-regulated businesses. This requires unfettered access to operating and financial information about non-regulated subsidiary operations and results. Because of discovery difficulties, including the time consumed in attempting to obtain non-regulated segment financial information that was not provided, and the time it took to acquire budget support for NSC allocations, Overland was unable to fully assess the reasonableness of cost allocation results and CalAm's compliance with California affiliate transactions rules.

Summary of Regulated and Non-Regulated Segments - AW's regulated and non-regulated businesses are summarized as follows.

Chapter 1

- Regulated Businesses Segment - AW describes the regulated segment as including the water and wastewater utility businesses subject to economic regulation. Cost allocation support provided in data responses indicates that this provides services to industrial, commercial and residential customers in 20 states.

- Non-Regulated Businesses Segment - According to AW, the non-regulated business segment is administered by subsidiary American Water Enterprises. Non-regulated businesses include homeowner water and sewer line maintenance, water and wastewater operations and maintenance services (for municipalities, water districts, U.S. military bases and similar entities), carbon technologies for water cleansing, water and wastewater facilities engineering and wastewater residuals management.[1]

In many cases, non-regulated business activities are linked operationally or administratively to the regulated water utilities. For example:

- The National Service Company includes many "corporate" and shared operating functions, including treasury, finance, accounting, operations and customer services, that are shared by regulated and non-regulated activities. Although the non-regulated segment accounted for about 12% of 2007 corporate revenue, less than 8% of 2007 National Service Company's national expenses were allocated or directly charged to non-regulated subsidiaries.[2]

- AW's business development function, which is primarily focused on development of non-regulated business opportunities, is situated organizationally within the National and Regional service companies that exist primarily to serve the regulated water utilities. Other functions in the Regional (Local) service companies, including engineering, accounting and others, contribute services to the non-regulated businesses.

- Non-regulated operations, maintenance and customer services are sometimes performed by employees of the regulated water utilities. For example, CalAm's Coronado district provides management, system operations, customer call center, meter reading and other services to the Descanso water system under a "regulated O&M" contract.[3] Costs are not allocated "below-the-line" (to shareholders) for these services; instead, it is Overland's

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[1] American Water Works Company, Inc., S.E.C. Form 424B3 (Prospectus), filed May 12, 2008, p. F-36.

[2] Based on analysis of data from OC-52. In 2007, NSC incurred approximately $183.4 million (this excludes amounts from regional service companies that was mixed in with national expenses). Of this, $14.1 million was directly charged or allocated to non-regulated subsidiaries, including amounts charged to what appear to be non-regulated water operations managed for municipalities whose revenues are actually included in the regulated segment. $169.3 million was charged to regulated water utilities.

[3] Response to data request OC-72.

understanding that in this case, in return for the use of regulated employees and assets, CalAm's ratepayers are credited with 10% of the revenues from the contract.[4]

Non-Regulated Services Provided by the Customer Service Center - We asked about services provided by the NSC to non-regulated companies and non-regulated customers. We learned that the Customer Service Center (CSC), from which CalAm is requesting to recover significantly higher costs than authorized in the prior rate case, performs services for a large number of non-regulated municipal customers. For the municipally-owned Liberty and Edison water companies and for a few smaller systems owned by others, AW provides customer services that it defines to be "comparable" to what it provides to the regulated water utilities. Operating agreements show that AW also provides other operating services, including system maintenance and management, to certain municipalities. Available time did not permit a detailed analysis of whether costs were properly allocated for all of the services provided.[5] We did investigate the services provided by the CSC. CalAm acknowledged that the CSC did not allocate any cost for the customer services provided to non-regulated municipal customers such as Liberty and Edison.

We found that revenue from non-regulated sources can be recorded by a regulated water utility. Several months after we asked about non-regulated customer services, CalAm provided a list of more than 100 municipalities that receive customer service under contract.[6] Although the contracts are between the municipalities and AW's regulated water companies, the services are provided by the National Service Company's Customer Service Center (CSC). AW declined to respond to our data request regarding the ratemaking treatment of the revenues associated with the contracts. However, the costs incurred by the CSC to provide the services are allocated to the regulated water companies, including CalAm (even though CalAm does not have any such contracts).[7] AW's failure to allocate any of the CSC's costs to the non-regulated category for these services increases the cost allocated by the CSC to CalAm.

Attempts to Review Non-Regulated Financial Results and Potential Affiliate Relationships - Early in the discovery process, we requested American Water's consolidating workpapers.[8] Consolidating workpapers typically provide a high level, pre-consolidation view of non-

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[4] It is Overland's understanding that such services are authorized by the California Public Utilities Commission under Advice Letters. It was beyond the scope of our review to audit the details of these arrangements.

[5] Many of these costs would be incurred by regulated AW water companies located near the municipality being served, rather than by the NSC.

[6] Supplemental response to data request OC-71 received August 12, 2008.

[7] Response to data request OC-216-E states that AW objects to the question about rate case treatment, asserting "it is not relevant to the current proceeding." Response to data request OC-210-A indicates "no customer service expense for 2007 or year-to-date 2008 was allocated to regulated state subsidiaries of American Water."

[8] Data Request OC-23. Overland routinely requests consolidating workpapers in reviewing affiliate transactions and cost allocations. We have obtained these workpapers from utilities in California and in other jurisdictions. Other than by American Water, we have never been denied access to a company's consolidating workpapers.

regulated subsidiary's financial results and are a starting point in the process of understanding the financial results of a company's non-regulated businesses. Consolidating eliminations and footnotes to the schedules in the workpapers often also provide insight into affiliate relationships and transactions. AW declined to provide its consolidating workpapers and the accompanying non-regulated financial information. After spending the equivalent of approximately 50 consulting hours chasing the information, we ceased efforts to acquire it.[9]

The accounting profession requires public companies to file a limited amount of high-level information about business segment operations and affiliate transactions in the notes to financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP). In American Water's case, such data is limited because, as a subsidiary of a German utility and British water company, AW was not required to file annual GAAP financials in recent years. Fortunately, AW's recent decision to raise public equity capital created a requirement to file public financial information, without which even high level financial information concerning the non-regulated segment would have been non-existent. With the information filed in a prospectus related to the public equity offering and recent quarterly financial reports filed with the Securities and Exchange Commission, we were able to determine that the non-regulated segment accounted for about 12 percent of AW's total "size" in 2007.

National Service Company Allocations (Regulated / Non-Regulated and to CalAm) - As discussed in Chapter 2, under Adjustment 14 (Correct Allocations to CalAm), CalAm was unable to provide calculation support for its test year-requested NSC allocation factors. We found CalAm's test year included an expense allocation to CalAm that is higher than suggested by a reasonable size-based allocation between the regulated and non-regulated business segments and between CalAm and other water companies within the regulated segment. As shown in Chapter 3, Table NSC-1, CalAm requests an overall 5.41% allocation of common NSC management fee expense to CalAm in the test year, after an ostensible (but incalculable) allocation to the non-regulated segment, even though CalAm's December, 2007 share of regulated customers is only 5.18%. Overland's composite allocation to CalAm, which Overland recommends for six of the NSC's nine rate filing categories, is 4.59%. It is based on an 88% regulated segment allocation (using relative regulated and non-regulated segment revenue and expense) and a 5.18% regulated expense allocation to CalAm (based on actual year-end 2007 customers).

Local Service Company Allocations (Regulated / Non-Regulated) - A review of schedules that show the distribution of the expenses of the Western Region Local Service Company (LSC) indicates that employees of the LSC's Business Development business unit spend approximately two-thirds of their efforts on non-regulated projects in the Western Region. These expenses are charged to American Water Enterprises (AWE), AW's largest non-regulated legal subsidiary.[10]

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[9] Overland requests consolidating workpapers as a routine part of its review of affiliate transactions and cost allocations in regulatory audits. This is the first time that our request for such workpapers has been denied.

[10] CalAm rate filing workpaper GO-126 shows the proposed test year distribution of expense between AWE and the regulated state jurisdictions in the Western Region.

Although expense distributions indicate that about two-thirds of Western Region business development activity is non-regulated, with the exception of two Administration unit employees who appear to be dedicated entirely to non-regulated subsidiary AWE (a Project Engineer and a Contract Operations Manager), no expenses from other LSC business units serving the Western Region (External Affairs, Finance, Human Resources, Legal, Environmental Management, Maintenance, Network, Operational) are allocated to AWE or to other non-regulated subsidiaries. As discussed above, early in this review we attempted to review the financial results of AWE and other non-regulated subsidiaries. AW and CalAm declined to provide consolidating financial results for AWE and other non-regulated subsidiaries. Given that more than half of the LSC's business development activities are non-regulated, it is likely that other LSC supporting activities should also be allocated to the non-regulated segment.

Recommendations

1. Rate Filing and Workpaper Organization and Referencing - We recommend the Commission require CalAm to organize rate filing and workpaper support in a hierarchical fashion, with summarized rate filing information rolling up from more detailed workpaper support. Quantitative information in the workpapers should tie forward either to more summarized workpapers, or to tables in the rate filing. All rate filing schedules and workpapers should be referenced so that the source data, and the workpapers that contain detail tying forward to the schedules, can be located. In other words, the filing and workpapers should contain referencing, cross-referencing and source identification that is standard in utility regulatory filings containing accounting data.

2. Rate Base and Overall Revenue Requirement Calculations - We recommend the Commission require CalAm to provide a calculation of its rate base, rate base revenue requirement and overall General Office revenue requirement in future rate filings.

3. Support for Service Company Expenses Included in the General Office Revenue Requirement - We recommend the Commission require CalAm to provide adequate support for expenses allocated from both the National and Local Service Companies in its next rate filing. The required support should include the following:

    - A table summarizing total test year and historical expenses allocable to CalAm for each expense category (e.g., for the NSC, customer service, shared services, finance, etc.).
    - A table summarizing test year and historical allocation factors applicable to CalAm for each expense category.
    - A table summarizing test year and historical amounts allocated to CalAm for each expense category.

- Business unit budget detail - Budgeted amounts by account for each business unit included in the NSC and LSC filings (equivalent to what was provided to Overland in OC-91).[11]
- Business unit allocation factors - Supporting allocation factor detail showing how the factors each budget unit separately allocated or charged to CalAm were calculated. In this filing CalAm asserted (in response to OC-51)for the NSC that no supporting detail for budgeted allocation factors exists.
- As described in additional detail in Chapter 4, should CalAm attempt to recover *any* cost associated with the NSC's Customer Service Center in future rate filings, we recommend the Commission require CalAm to file workpapers showing how expenses for CSC services provided to non-regulated customers (such as the billing and collection services provided to more than 100 municipalities) are fully distributed to the non-regulated segment and / or customers.

4. An Affidavit or a Statement in Testimony Confirming That Commission Requirements Have Been Met - To the extent the Commission adopts the recommendations above, we further recommend that the Commission require CalAm to include an affidavit in the rate filing or a statement by the appropriate witness that the specific rate filing support recommendations required by the Commission have been met.

5. DRA Access to Non-Regulated and Affiliate Transactions Data - As discussed elsewhere in this report, our ability to assess the impact of non-regulated operations on CalAm and its revenue requirement was limited because of limits CalAm and AW placed on non-regulated subsidiary data. When access to financial and operating data is limited, it is not possible to assess the reasonableness of affiliate transactions and common cost allocations. Prior to this review, it was Overland's understanding that DRA and auditors working on DRA's behalf have the right, under the California Public Utility Code, to review non-regulated financial and operating data for any utility affiliate that they deem necessary to determine whether cross subsidization of non-regulated activities by regulated utility customers may be occurring. To the extent that it not clear that DRA already has the right to review the financial and operating data of CalAm's affiliates, we recommend the Commission specifically require CalAm to make such information available in future rate and other proceedings in which affiliate transactions, cost allocations and related possible cross-subsidization are potential subjects or issues. We also recommend the Commission require that CalAm include, in its next rate filing, an affidavit or a statement in the testimony of an appropriate witness confirming that the books and records of non-regulated subsidiaries will be made available for review by DRA or its agents subject to the execution of an appropriate confidentiality agreements.

[11] Labor detail showing the names and salaries of employees, included on a separate sheet within each business unit budget excel file, can be omitted if determined to be confidential. However, rate filing support should include a note to the effect that labor expense detail is available for review upon request by auditors covered by an appropriate confidentiality agreement.

2. Adjustments to CalAm's General Office Revenue Requirement

This chapter summarizes Overland's adjustments to California American Water Company's (CalAm's) General Office (GO) operating expense revenue requirement. Overland's recommended adjustments affect: 1) GO O&M expense incurred by the service companies; 2) allocations of GO O&M expense to CalAm; and 3) allocations of CalAm's GO O&M to CalAm's districts. Overland is not recommending adjustments to CalAm's proposed test year rate base or rate base revenue requirement. This chapter addresses adjustments at the CalAm level. Allocations of CalAm's revenue requirement to CalAm's California districts is discussed in Chapter 8.

Overland's Recommended Adjustments to Test Year as Filed by CalAm

The table below summarizes CalAm's GO operations and maintenance (O&M) expense, as filed by CalAm for the 2008 and 2009 forecast years. It also shows Overland's recommended O&M adjustments and test year GO O&M as recommended by Overland.

Ta e 2 1
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S a of A e o Te ea To a Ca fo a A

Adj. No.	Item	2008	2009
	O O e a g E e e Pe Ca A A e	17 060 572	16 858 609
	O e a Re o e e A e		
1	Annualize Labor Expense Based on May 31, 2008 Actual Staff Levels	(338,591)	(380,171)
2	Reduce Incentive Compensation to 2007 Actual Award Levels	(589,158)	(598,546)
3	Remove Business Development Expense	(371,469)	(383,185)
4	Remove Corporate Contributions	(20,623)	(20,623)
5	Remove Legislative Influence Expense	(211,004)	(218,213)
6	Remove Unsupported "NSC Functions" Expense	(545,959)	(82,520)
7	Correct Non-Deparmental Interest Income and Income Tax	38,195	38,195
8	Remove Sales and Marketing Expense	(72,056)	(72,056)
9	Limit Customer Service Center Expense to 2003 Expense per CalAm Customer (Before National Call Centers) Plus Price Inflation	(831,111)	(831,111)
10	Remove Unnecessary Payroll Reserve	(30,050)	(30,801)
11	Correct Omission of Operating Risk Dept Salaries	-	83,036
12	Reverse Allocation Effect of Re-branding LSC Employees as CalCorp	(321,011)	(334,197)
13	Remove CalCorp Labor Separately Requested as Rate Case Expense	(33,236)	(34,664)
14	Correct Service Company Allocations to CalAm	(765,157)	(767,334)
	To a A e Re o e e O e a	4 091 231	3 632 190
	O O e a g E e e A Re o e e O e a	12 969 341	13 226 419

Source: Attachment 2-1

Attachment 2-1 provides additional detail for the adjustments listed above. NSC 2009 test year expenses, as calculated by CalAm for the rate filing, are based on the NSC's 2008 budget. The salary component of labor expense, and labor costs tied to salaries (e.g. payroll taxes) are budgeted for 2008 based on 2007 salaries plus across-the-board salary inflation of 4%. Overland did not adjust these basic assumptions made by CalAm about test year NSC expense.

Chapter 2

<u>**1. A e oA a e a o oRef e A a ge ea S aff g**</u> - Labor expense accounts for more than two-thirds of CalAm's GO revenue requirement request. Overland recommends test year labor expense for General Office employees based on actual employees on the payroll as of May 31, 2008. We believe actual staffing at a point nearly mid-way through the 2008 budget year is a better indicator of the test year labor expense AW is likely to incur than expense based on a budget prepared in the fall of 2007.

Calculating test year labor expense using actual 2008 staffing reduces CalAm's requested test year GO expense, using CalAm-requested allocation factors, by $338,591 in 2008 and by $380,171 in 2009. The individual components of the adjustment are as follows:

- <u>NSC</u> - The adjustment reduces total NSC expense by $1,989,537 and reduces regulated expense allocated to CalAm (using CalAm-requested factors) by $69,934 in 2008 and 2009. These amounts exclude an adjustment to Customer Service Center (CSC) labor expense, which would need to be added if the Commission rejects our recommended adjustment to CSC expense, discussed below.[1]

- <u>LSC and Cal Corp</u> - The adjustment reduces total LSC and Cal Corp expense by $296,949 in 2008 and $340,253 in 2009. It reduces CalAm-allocated expense by $268,657 (2008) and $310,237 (2009). LSC allocations to CalAm include the impact that Overland's calculated labor expense would have on non-labor calculated allocators.

<u>The Basis for Overland's Recommended Labor Expense</u> - Overland conducted an analysis comparing staffing in the budget to actual staffing as of May 31, 2008. The table below summarizes this analysis.

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[1] Overstated budget labor expense associated with the Customer Service Center (CSC) is $2,161,256 (total NSC) / $117,140 (CalAm-allocated using CalAm's factor) for both 2008 and 2009. As discussed below, we recommend test year CSC expense be limited to 2003 expense recorded by CalAm (2003 was prior to the implementation of national call centers), adjusted for inflation between 2003 and the test year. If the Commission rejects the recommendation to limit CalAm CSC expense, but accepts our test year labor expense calculation, the NSC component of the test year labor adjustment would need to be revised to $4,150,793 (total NSC) / $208,065 (CalAm-allocated). The revision is necessary to account for the overstated labor expense associated with the CSC in the test year labor expense calculation.

Chapter 2

Ta e 2 2 A e a ae Se e Co a ge e . A a ea o Ma 2008		
	May 31, '08 Headcount	
Rate Filing Category	Budgeted	Actual
NSC Belleville Lab	36	30
NSC Customer Service	750	697
NSC Finance	59	58
NSC Human Resources	36	30
NSC Info Technology	185	165
"NSC Functions"	51	48
NSC Operations / Netwk	69	63
NSC Shared Services	202	179
NSC Supply Chain	37	38
Total NSC	1,425	1,308
Total LSC	57	54
Total Cal Corp	51	40
To a Se e Co. S aff A o a e o Ca A	1 533	1 402
Source: OC-91 and OC-92- Excludes Interns		

Service company employee levels have increased steadily in the past few years. For example, the NSC had 1,111 employees at the beginning of 2006.[2] AW's budget predicts a mid-year, 2008 NSC employee level of 1,425, 28% more than at the beginning of 2006, and 9% higher than actual end-of-May, 2008 staff levels. Meanwhile, CalAm's regulated customers, on which allocation of NSC expense to CalAm is based, have increased only 2% over the past five years.[3] The forecasted increase in staffing, without a commensurate increase in customers, shows that CalAm is projecting that GO services provided to California will continue to become *less* efficient in the test year, continuing (and perhaps accelerating) a trend that has been in place for the past several years.

<u>Overland's Calculation of Test Year General Office Labor Expense</u> - Overland's calculation of NSC labor expense is based on the salaries, benefits and payroll taxes for *actual* employees as of May 31, 2008. 2008 budgeted salaries are based on 2007 salary levels plus a 4% across-the-board increase. Overland's recommended labor expense calculation also incorporates AW's budgeted salary increase. AW's NSC labor expense calculation includes an allowance for vacancies. The vacancy allowance is a fraction of the difference between actual and budgeted labor expense as of May 31, 2008. Overland's labor expense adjustment reverses AW's vacancy allowances to avoid double-counting the related expense reduction AW recognized in its 2008 budget.

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[2] Analysis of data provided in response to OC-92.

[3] 171,444 (12/31/2007 customers per OC-90) / 167,834 (2003 customers per Rate Filing Exh.B, Ch.9, Sec.1, Tbl. 6) = 1.0215.

Chapter 2

Our recommended test year labor expense for the LSC and Cal Corp is also based on the actual employees in each of these organizations as of May 31, 2008. Since the company budgeted labor costs at an employee level, projected positions that were vacant were deducted from CalAm's request - 8 from the LSC and 12 from Cal Corp.[4] The LSC had 7 employees in its organization in May 2008 that were not specifically included in its request.[5] For these 7 employees, Overland increased the company's request by using actual 2008 annualized salary and benefits along with jurisdictional and operating expense/capital expenditure allocations. Overland assumed a 4% annual increase in labor expense for 2009 for these additional employees, the middle of the 3% to 5% range budgeted by AW for LSC and Cal Corp employees. Finally, the LSC's projected non-labor allocations are a function of cumulative labor cost allocations. Overland recalculated these non-labor allocations based on the LSC organization as it existed in May 2008.[6]

2. Re e ge e E o ee e e Co e a o - CalAm's requested test year incentive compensation appears to be based on the following assumptions: 1) that all budgeted positions at management levels eligible for incentive compensation will receive it; and 2) that eligible positions will receive 100% of their incentive awards using a budget assumption that 100% of the plan (corporate and regional) income targets are achieved.[7] Overland questions both of these assumptions. Overland recommends that GO incentive compensation be limited to amounts actually paid for 2007, adjusted for salary inflation, and limited to employees in salary bands for which CalAm provided requested incentive plan documents.[8] This amount is significantly lower than CalAm's test year-request incentive compensation, which is based on budgeted GO incentive compensation of $7.2 million for the NSC (2008 and 2009), $0.8 million for the LSC (2008 and 2009) and $0.5 million for Cal Corp (2008 and 2009) (before allocation to CalAm).

Using CalAm's allocation factors, Overland's recommended incentive compensation adjustment reduces CalAm's NSC-allocated expense by $328,033 in 2008 and in 2009. Our recommended

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[4] Two Business Development positions in the LSC that were vacant as of May 2008 were excluded from this adjustment as they were captured in Overland's recommendation to disallow the costs of this entire function.

[5] Cal Corp had one employee in May 2008 that was not included in CalAm's request (see response to OC-166). Because this employee had been captured in the LSC organization for GO rate filing purposes, Overland elected not to remove the costs of this employee from the LSC and to add back the costs to Cal Corp.

[6] Even though the LSC was effectively reduced by 1 net position (8 vacancies LESS 7 new positions), Overland's recalculation of CalAm's allocation resulted in an increase to the company's request. This is due to the nature of the positions adjusted (vacant positions had on average smaller allocations to CalAm than the "new" positions added by Overland) both directly on labor costs and indirectly on non-labor costs.

[7] According to Attachment A of the 2007 AIP document provided in response to OC-16, payouts could conceivably be as much as 150 percent of budgeted payout if operating income is as high as 125% of target.

[8] AW's General Office service company budgets reflect across-the-board 4% salary increases for all employees. Overland accepts this estimate, and it is applicable to both salary and incentive compensation.

adjustment reduces CalAm's LSC-allocated and Cal Corp-charged expense by $261,125 in 2008 and by $270,513 in 2009 (in both cases based on CalAm's requested LSC allocation factors).

Regulatory Background - Incentive compensation was not included in revenue requirements in the prior two General Office rate filings. The most recent General Office rate case decision (D.06-11-050) states that in reaching a settlement with DRA, CalAm agreed to remove incentive compensation from its rate request.[9] In the 2003 Monterey rate case decision (which also addressed General Office expenses), the Commission denied CalAm's request for recovery of forecasted incentive compensation, noting that the requested amounts were "only estimates," and that CalAm had paid substantially less incentive pay than it had budgeted in two of three historical periods it cited.[10]

In its direct testimony, CalAm references the Commission's 2003 finding that CalAm's actual incentive compensation payout was substantially less than had been budgeted. CalAm's witness Buls states that "under the present mechanism, the forecasted AIP payouts should much more closely track actual payouts."[11] However, Overland found that in 2007 only 35 of approximately 700 NSC management employees received any incentive plan payments, and not all of these employees received 100% of their potential payout.[12] For the NSC, actual 2007 payments were about 12% the amount budgeted for the NSC in 2008. For the LSC, 2007 actual incentive plan payments were approximately 63% of the 2008 budget, and for Cal Corp 2007 actual payments were approximately 56% of the 2008 budgeted amount.

Background on AW's Annual Incentive Plan - We requested AW's Annual Incentive Plan (AIP) documents in data requests OC-16 and OC-182. CalAm sent us 2007 (and later 2008) plan documents applicable to lower and middle management employees (those from salary bands 14 through band 5). These employees are eligible for incentive pay of between 5% and 20% of their base salaries. Business unit budgets provided in response to OC-91 show that 2008 budgeted incentive compensation also includes compensation for employees in salary bands ML4, 3 and 2 (Vice President and above). These employees are eligible for incentive compensation of up to 50% of their base salaries. CalAm did not provide AIP documents applicable to these higher-level employees. Because the documents were not provided, Overland did not evaluate the basis for incentive compensation for these employees.

Based on the AIP document provided for lower and middle-management employees, incentive compensation for employees in salary bands 14 through 5 is based on up to four performance components, including separate regional and corporate financial performance, operational

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[9] Decision 06-11-050, p.30.

[10] Decision 03-02-030, General Office - Salaries, p.24.

[11] Direct testimony of Christopher Buls, p.26.

[12] Response to data request OC-194, attachment OC-194.xls.

performance (measured in terms of customer satisfaction, service quality, environmental and health and safety factors), and individual employee performance.

Test year budgeted incentive plan payments for the financial performance components are based on achieving 100% of an operating income target, but no incentive compensation based on *any* component can be paid unless Corporate Operating Income is at least 75% of the corporate targeted amount.[13] With respect to financial performance for 2008, in the first quarter AW was required to write off more than $700 million in goodwill and recognize an associated impairment loss. As a result, AW recorded a net loss of $687 million for the first half of 2008, compared with net income of $52 million for the six months ending June, 2007.[14] In addition, concern over cash flow improvement caused Standard & Poor's to downgrade AW's bonds to BBB+ from A- in June, 2008.[15]

With AW's large impairment loss, a net loss for the year is very likely. Although a goodwill impairment loss does not necessarily affect the incentive plan's Corporate Operating Income target, it is hard to imagine AW awarding the significantly higher incentive compensation for 2008 (compared with 2007) if it records a net loss for the year. Although an impairment loss does not necessarily affect the incentive plan's income target, operating cash flow can. The S&P downgrade, which is based on concern about cash flow growth, does not augur well for operating income. Given that a 75%-of-targeted income threshold must be achieved before incentive compensation can be awarded, it is not clear whether any incentive compensation can be awarded for 2008. We believe it is also an open question whether significant incentive compensation will be paid in 2009.

With respect to the individual performance component of the incentive plan applicable to lower and middle management employees, AW's budget assumption appears to be that every incentive plan-eligible employee will be rated as having performed at a level that qualifies for the maximum payment attributable to the individual, a result we believe is unlikely. If it were to occur, it would render meaningless any "incentive" linking compensation and performance.

<u>Overland's Recommended Incentive Compensation Expense</u> - As discussed above, we believe it is possible, if not probable, that AW will not meet the minimum Corporate Income threshold necessary to award the first dollar under its the 2008 lower and middle management incentive compensation plan. Nevertheless, Overland conservatively recommends providing test year ratepayer funding based on actual 2007 incentive awards made to lower and middle management employees (for which AIP documents were provided), plus inflation based on AW's budgeted salary increases. 2007 payments under the incentive plan were significantly below what AW budgeted in 2008. For example, as noted above, 2007 incentive compensation was awarded to only 35 NSC employees in the business units allocated to CalAm, whereas the 2008 NSC budget

[13] Response to OC-182, 2008 Annual Incentive Plan, Salary Bands 14-5, p.5.

[14] American Water Works 10Q, 3 months ending June 30, 2008, as summarized by MarketWatch (www.marketwatch.com/news/story/10-q-american-water-works-company).

[15] Reuters, June 19, 2008, Standard and Poors Ratings Services news release.

reflects incentive compensation for more than 700 NSC employees. Overland's recommended General Office incentive compensation is summarized below.

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Ca fo a A e a a e
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O e a Re o e e Te ea e e a Off e E o ee e e Co e a o

Ln	Item	NSC 2008	NSC 2009	LSC 2008	LSC 2009	CalCorp 2008	CalCorp 2009	Total 2008	Total 2009
1	2007 Actual Incentive Pay - Employees in Management Salary Bands 5-14	275,862	275,862	385,121	385,121	257,810	257,810	918,793	918,793
2	Labor Inflation	1.04	1.04	1.04	1.08	1.04	1.08		
3	2008 Recommended Incentive Pay Based on 2007 Actual Incentive Pay - Adjusted for Salary Inflation	286,896	286,896	400,526	415,931	268,122	278,435	955,545	981,262
4	Subtract NSC Incentive Pay Attributable to CSC (1)	22,227	22,227						
5	Test-Year Recommended GO Incentive Comp Based on 2007 Actual Incentive Comp Payments	264,669	264,669	400,526	415,931	268,122	278,435	933,318	959,035

(1) It is not necessary to provide incentive pay for the CSC because Overland is recommending 2008 budgeted CSC expense be replaced with 2003 actual CSC expense adjusted for inflation.

After allocation to CalAm, using CalAm's recommended allocation factors, Overland's recommended ratepayer-funded General Office incentive compensation is $252,625 in 2008 and $261,156 in 2009.[16]

3. Re o e e e eo e E e e - CalAm's current General Office rates do not include business development expenses. CalAm's regulated customer base has been stagnant since at least 2003. Overland recommends no ratepayer funding of expenses allocated from NSC and LSC business development functions. The adjustment to remove business development expense reduces General Office expense allocated to CalAm by $371,469 in 2008 and $383,185 in 2009, calculated using CalAm-requested allocation factors.

NSC - The Corporate business development function is included in a business unit within the "NSC Functions" rate filing category. It took approximately three months of discovery effort to uncover that Corporate Business Development was allocated to CalAm as part of "NSC Functions" rate filing category. Once we became aware of its existence, we asked CalAm to

[16] For 2008: NSC, $15,395; LSC, $112,271; Cal Corp $124,959. For 2009: NSC, $15,395; LSC, $116,308; Cal Corp, $129,453

describe corporate business development projects benefiting CalAm's regulated operations. CalAm responded:[17]

> The role of the Corporate Business Development function is to provide coordination, tools, training and support the Business Development (BD) teams in the local operations . . . In many of these activities, there is no project number or specific state / location to charge and time is charged accordingly. In recognition of the fact that a significant proportion of the activities are non-regulated, 2008 budgeted charges for this function are allocated to regulated subsidiaries in a much lower proportion that other corporate functions.

We found that a "much lower proportion" allocated to regulated companies is still a majority of the total cost (56.43%).[18]

There is no evidence that the NSC's corporate Business Development unit has added or will add customers or revenue to CalAm's regulated operations. Overland therefore recommends excluding the expense from allocation to CalAm for purposes of rate-recovery. Removing business development reduces expense allocated to CalAm by $30,439 in 2008 and the 2009 test year, using CalAm's requested allocation factors.

<u>LSC</u> - CalAm proposes to recover LSC business development expense by suggesting that current ratepayers benefit from the customers added by business development efforts, which permits CalAm to spread its overhead over a larger group of customers. This might be justified if the benefits of adding new regulated customers exceed the costs, but in this case, they do not. CalAm proposes incurring $352,746 of additional <u>annual</u> LSC Business Development costs at the same time it projects to add only 3,400 customers to its customer base over a two-year period. Even ignoring the fact that some of the customer increase, if it occurs, will result from internal growth, CalAm's proposal effectively increases the LSC's expense allocation per CalAm customer by nearly 9% ($20.44 vs. $18.78 annually – see Chapter 5 for more details). Coupled with the fact that a portion of the "regulated" business being generated by this LSC group is being categorized as coming from "regulated O&M" projects (the revenues from which are primarily attributed below-the-line, to non-regulated business), Overland believes that ratepayer funding of LSC business development should not be permitted. Our adjustment to remove business development expense allocable to CalAm reduces total LSC expense by $1,953,711 and $2,020,833 in 2008 and 2009, respectively. The adjustment reduces LSC business development expense allocated to CalAm by $341,030 in 2008 and $352,746 in the 2009 test year, using CalAm's requested allocation factors.

<u>4. R NSC C C E</u> - Utility regulators, including the California Public Utilities Commission, have traditionally prohibited utilities from charging ratepayers for their charitable contributions. Perhaps the most obvious reason for recording

[17] Response to OC-141.

[18] Response to OC-91 (NSC budget data), 032020_CorpBusDev_2008-2012.xls, "Rates" sheet.

charitable contributions below-the-line (in expense accounts other than those recovered from ratepayers) is that if the expense is charged to ratepayers, it is the ratepayer, not the utility, that makes the donation. To the extent a utility selects a charity and chooses to make a donation, either in the form of cash or donated labor, the utility (through its shareholders) should actually pay it. Ratepayers should be free to select their own charities and make their own donations; they should not be compelled to make donations on behalf of a utility.

Our adjustment removes $240,500 charged to account 575140 - Charitable Contributions Expense from budgeted NSC expense allocable to CalAm regulated ratepayers. In addition, we recommend removing $195,670 from several accounts (Other Employee Welfare, Contract Services and others) budgeted for NSC business unit 32087 - Corporate Social Responsibility. After the impact of locational overheads is factored into the amounts removed, our adjustment reduces NSC budgeted non-labor expense by $420,021. Using CalAm's requested allocation factor, the adjustment reduces expense recoverable from CalAm's ratepayers by $20,623 in 2008 and the 2009 test year.

. R P E - In the 2004 General Office rate case, the Commission disallowed expense associated with a Government Affairs Director when it became clear that the position included legislative influence responsibilities.[19] It is Overland's experience that regulators in general, and the California Public Utilities Commission in particular, prohibit utilities from charging ratepayers for expenses incurred to influence politicians or legislation. Overland identified legislative influence expenses in the NSC and Cal Corp budgets. We recommend removing all such expenses from ratepayer-funded GO expense. Our recommended adjustment reduces expense allocated to CalAm by $211,004 in 2008 and by $218,213 in the 2009 test year.

NSC - In data request OC-21 we requested the job descriptions for all NSC positions. One of the job descriptions omitted from the response was the NSC Director of Government Affairs. We re-requested this job description in OC-192. In this request we also asked for a description of consulting expenses budgeted for the NSC's Government Affairs business unit (part of the "NSC Functions" rate filing category). It is clear from the response that both the Director's responsibilities and the consulting efforts involve legislative influence. For example, the job description includes the following:

> Federal level - Provide a strategy that will bring American Water to the table with federal lawmakers.

The description of the budgeted consulting expense indicates that the consultant's responsibilities include working as an extension of the External Affairs department to develop and implement a successful legislative strategy.

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[19] Decision 0302030. General Office - Salaries, pp. 21-22.

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Overland recommends removing the expense budgeted for business unit 32022 - NSC Government Affairs, from expense recoverable from ratepayers. This adjustment reduces allocable NSC expense by $459,562 in 2008 and the 2009 test year. Using CalAm's requested allocation factor, our recommended adjustment reduces NSC expense allocated to CalAm by $22,564 in 2008 and 2009.

Cal Corp - While not always referred to in a consistent manner from data response to data response, Cal Corp employed an individual in May 2008 that was responsible for governmental affairs. This position reported to the regional president.[20] The only Cal Corp job description provided that remotely matches this position is the Director of Governmental Affairs. As described in this position's job responsibilities, this employee was to "influence proposed legislation", develop working relationships with legislators, and coordinate personal contacts with elected and appointed officials among other duties.[21] These are the same responsibilities of a position specifically reviewed and disallowed by the Commission in a previous case. Overland recommends the same rate treatment in this application. Overland's recommended adjustment reduces Cal Corp expense charged to CalAm by $188,440 in 2008 and $195,648 in the 2009 test year for labor expense associated with the Director of Governmental Affairs. No adjustment to LSC expense is necessary.

6. Re o e U o e "NSC o " E e e - Overland recommends removing expenses in the"NSC Functions" rate filing category that do not meet regulatory standards required for ratepayer recovery. Our recommended adjustment includes the three separate components. In total, it reduces expense allocated to CalAm by $545,959 in 2008 and $82,520 in the 2009 test year.

- 2008 "NSC Functions" Expense Not Supported by the 2008 NSC Budget - Supporting NSC budget data provided in OC-91 includes amounts for the business units CalAm disclosed as belonging to the "NSC Functions" rate filing category that, when allocated to California using CalAm's proposed factors, total $1,026,220. For 2008, CalAm included $463,439 in additional NSC Functions expense in the rate filing (CalAm, post-allocation), for a total "NSC Functions" expense of $1,489,659.[22] The additional amount is unsupported. It may have been added to 2008 to show a declining amount of NSC-allocated expense between 2008 and the 2009 test year. This component of our adjustment reduces CalAm-allocated NSC expense by $463,439 in 2008 only.

- $1 million Risk Reserve - The "Non-Departmental" business unit includes a $1 million expense described in the budget as "risk reserve for EW."[23] In response to our data

[20] Responses to OC-2 and OC-92.

[21] Response to OC-21.

[22] See, for example, Exhibit B, Chapter 4, Section 1, Table 1 in CalAm's original (January 30, 2008) or updated (May 9, 2008) General Rate Case Application, A.08-01-024.

[23] "EW" are the Chief Financial Officer's initials, who authorized the budgeted reserve.

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request on the subject, it was described as a contingent expense included because "it is impossible to identify every event that could occur."[24] The data response further indicates that such expenses might be incurred in California after an earthquake. Overland recommends removing this speculative, contingent expense from NSC expense charged to CalAm ratepayers. In addition, it is Overland's understanding that such a risk reserve is unnecessary because the California Public Utility Code permits utilities to set up a memorandum account to capture the costs associated with a catastrophic event. Using CalAm's requested allocation factor, this adjustment component reduces CalAm expense by $57,100 in 2008 and 2009.

- Labor Expense for a "Non-Departmental" External Affairs Director - Included in the "Non-Departmental" business unit is the labor expense for an employee listed as "Director External Affairs". We asked CalAm to explain what this employee's responsibilities were, why the employee was not included in one of the External Affairs business units, why an External Affairs Director's position paid a salary higher than the Senior Vice President of External Affairs and whether the responsibilities of the position included lobbying government officials.[25] AW declined to provide the information. Overland recommends that this unsupported, and likely unrecoverable, expense be removed from NSC expense charged to CalAm ratepayers. Using CalAm's requested allocation factor, this component of our recommended adjustment reduces CalAm's requested test year expense by $25,420.

. Co e NSC o e Ta E e ea e e o e - Among the items in the "Non-Departmental" business unit budget are interest income and income tax expense. Based on updated budget estimates provided by CalAm, Overland recommends adjustments to income tax and interest income that increase total NSC expense by $668,910, and increase CalAm's ratepayer-funded expense by $38,195, using CalAm-requested allocation factors. The adjustment amounts apply to 2008 and the 2009 test year.

- Interest Income - The 2008 NSC budget includes $2.4 million in interest income associated with NSC bank balances. In response to a data request, AW stated that interest income was over-estimated when budgeted in 2007. AW estimated that based on the first half of the year, interest income for 2008 will be about $1 million, rather than $2.4 million.[26] Overland recommends accepting AW's updated, lower estimate of interest income. This requires an adjustment reducing NSC-budgeted interest income by $1,427,200 (from $2,443,000 to $1,016,000). Because it an income item within the NSC expense budget, the adjustment *increases* CalAm's ratepayer funded expense by $81,493 in 2008 and 2009, using CalAm's recommended allocation factor.

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[24] Response to OC-162.

[25] OC-163.

[26] Response to OC-191.

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- Income Tax Expense - AW stated that $879,828 in income tax expense (pre-allocation) included in the "Non-Departmental" business unit is associated with expense that is not deductible for tax purposes, primarily non-deductible business meals.[27] There is not nearly enough non-deductible meal expense budgeted in 2008 in the business units allocable to CalAm to account for the income tax expense. AW offered a new, lower calculation of income tax based primarily on $546,000 in non-deductible meals and $12,000 in non-deductible dues. The actual amount budgeted in 2008 for non-deductible meals is $334,275. Overland recommends income tax expense on non-deductible employee meals be limited to the amount budgeted for the NSC business units that CalAm is requesting to recover from California ratepayers. Before allocation, the revised calculation of income tax expense is $121,537. This component of our recommended adjustment reduces AW's 2008 budgeted NSC tax expense by $758,291. Using CalAm's recommended allocation factor, this adjustment component *reduces* CalAm expense by $43,298 in 2008 and in 2009.

8. Re o e NSC Sa e a Ma e g E e e - Overland recommends that corporate Marketing and Sales expenses involving promotion of the corporate brand be removed from NSC expenses recovered from CalAm's ratepayers. Sales and Marketing business unit 32068 includes a Marketing Director, a Brand Manager, a Manager of Advertising and Trade Events and a Communications Specialist. The responsibilities of the Brand Manager include "leading the development and rollout of American Water's new visual style and new brand policy and standards." The responsibilities of the Trade Events and Advertising Manager include "lead[ing] initiatives that promote brand American Water or any of its products & services." We did not receive a requested job description for the Marketing Director.

Regulators do not typically permit utilities to charge captive utility customers for advertising or marketing unless the efforts are aimed at educating the customer about safety issues or service usage. NSC Marketing and Sales positions focused on brand management and brand promotion are far removed from the objective of educating CalAm customers about safety or service usage. Our recommended adjustment removes $1,467,534 from NSC total expense. Using CalAm's requested allocation factors, this adjustment reduces CalAm expense by $72,056 in 2009.

. C o e Se e Ce e CSC E e e o 2003 E e e P f a o - CalAm requests that it be permitted to recover from ratepayers nearly 70 percent more for customer service in the test year than it incurred in 2003.[28] Overland recommends limiting CalAm's CSC expense to $1,971,507 based on the *per-customer* expense incurred in 2003, adjusted upward by for inflation.[29] CSC expense comprises about one-third of the total NSC expense requested by

[27] Id.

[28] General Office Rate Filing Exhibit B, Chapter 4, Section 1, Table 1, Service Company - Call Center, $2,802,618 in 2009, 69.5% higher than $1,653,390 in 2003. 2,802,618 / 171,444 (OC-90) = $16.347.

[29] Inflation is based on the change in the Consumer Price Index between May, 2003 and May, 2008 (U.S. BLS., 125.6 / 107.6 = 1.1673; Dec. 1999 base=100, Chained, U.S. City Avg.). $1,653,390 (Ex.B, Ch.4, Sec.1,Tbl.1) / 167,834 (Ex.B, Ch.6, Sec.1, Tbl.3) = $9.8513 x 1.1673 x 171,444 (OC-90) = $1,971,507.

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CalAm, and about one-sixth of requested General Office expense. CalAm requests to recover test year expense of $16.24 per customer for the CSC (based on CalAm's proposed test year customers), up from just $9.85 in 2003, the year before national-scope call centers were fully deployed. The requested increase far exceeds consumer price inflation during this period, which results in expense per customer of $11.50.[30] As discussed more fully in Chapter 4, CalAm's transition from a local customer call center in Chula Vista to the allocated expense of national call centers in Alton, IL and Pensacola, FL has produced dis-economies for CalAm. One factor contributing to a significantly higher expense for CalAm may be AW's provision of call center services to non-regulated customers.

In light of the significant, unexplained increases in CSC expense per customer, Overland recommends that CalAm be prohibited from passing along apparent dis-economies associated with the implementation of the Alton and Pensacola centers, some of which may be attributable to non-regulated activities. Our adjustment reduces CalAm's requested level of CSC expense by $831,111, from $2,802,618 to $1,971,507 in 2009.

10. Re o e U e e a Pa o Re e e - Overland recommends an adjustment to remove a CalAm-allocated LSC payroll reserve for "bonus or promotional increase[s]." 2009 LSC expense allocated to CalAm already includes pay and benefit increases ranging from 3 to 5%, as well as incentive compensation. Layered on top of the salary increases and incentive compensation, CalAm proposes to include a "catch-all" reserve for unexpected raises, promotions, and unanticipated, market-driven increases to fill vacant positions. No apparent consideration is given to mitigating circumstances such as the possibility of filling position vacancies with employees who have less seniority than those being replaced, the potential softening of future job markets, or the ability of management to control future pay increases. Overland does not believe that the additional payroll reserve is warranted and proposes that it be excluded from CalAm's allocated GO costs. Our recommended adjustment reduces CalAm-allocated expense by $30,050 in 2008 and $30,801 in 2009, using CalAm-requested allocation factors.

11. Co e O o of O e a g R e a e Sa a e - CalAm inadvertently excluded the base salaries of two employees from the LSC Operating Risk Department projections in 2009. These same employees' base salaries were included in the 2008 projections. Total labor expense omitted was $154,092 for the LSC, of which $83,036 distributes to CalAm using CalAm-requested factors. Overland recommends an adjustment to correct this error by adding back the expense. This adjustment increases CalAm expense by $83,036 in 2009.

12. Re e e A o a o a of Re a g SC E o ee a Ca fo a O - Overland recommends that 12 of 17 employees reclassified in 2006 and 2007 from the LSC organization to the Cal Corp organization be allocated to the states served by the LSC as they were before they we re-branded as Cal Corp employees. In 2006 and 2007 AW moved 17 regionally-allocated LSC employees to the California-specific Cal Corp. Under the auspices of creating a "strong state organizational structure", these employees, who were once allocated to as

[30] $9.8513 x 1.1673

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many as five different regulated jurisdictions, are 100 percent attributable to CalAm for purposes of CalAm's project test year expense request. Although they have new locations on AW organization charts and new California-only cost attributions, 16 of the employees have continued to work in the same city, most with the same or similar job titles as they did when they were considered part of the LSC.

The re-branding of LSC employees as Cal Corp poses a potential for the manipulation of cost allocations. For example, an employee deemed to be part of Cal Corp in this rate application can be transferred back to the LSC or to another jurisdiction soon afterwards and be claimed as a partially- or wholly-dedicated employee of the transferred-to jurisdiction in a different rate case. We attempted to obtain information concerning rate cases in the other states served by AW's Western Region LSC and did not receive a meaningful response.[31]

We also found that the increase in Cal Corp costs associated with the re-branding was not offset by any meaningful decrease in CalAm-allocated costs from the LSC (as one would expect if the services being provided had actually been transferred).

Taking into consideration subsequent employee reclassifications and a few cases in which employees had obvious new job responsibilities, Overland recommends that 12 of the 17 reclassified employees be allocated across LSC cost objectives as they were before the re-branding to Cal Corp occurred. For purposes of this calculation, Overland used the allocations from the calendar year most representative of the date the employee "shift" took place.[32] Our recommended reallocation reduces CalAm expense by $321,011 in 2008 and $334,197 in 2009.

13. Re o e Ca Co a o Se a a e Re e e Ra e Ca e E e e - In its request, CalAm has included a portion of the labor costs of four Cal Corp employees in both its allocated operating expenses and deferred rate case expenses.

For 2009 test year purposes, labor for each employee of Cal Corp was assigned by management to either 1) operating expense or 2) capital expenditures and/or rate case expense through the use of allocation factors. In total, these allocation factors summed to 100 percent. Based on a review of deferred rate case expense support, Overland discovered that some employees had more time allocated to rate case expense than management had allowed for in its allocation factors. As a result, more than 100 percent of these particular salaried employees' labor costs were effectively requested for recovery from ratepayers.

[31] States served by the Western Region LSC, in addition to California, include Arizona, Texas, New Mexico and Hawaii. Operations in New Mexico, Texas and Hawaii are relatively small in comparison to California and Arizona.

[32] If the reclassification occurred near the end of a calendar year, we used the LSC allocation factors for that year. If the reclassification occurred near the beginning of a calendar year, we used the LSC allocation factors for the year prior to the move.

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Taking into consideration previous proposed adjustments that affect the recommended allocations of two of the four employees, Overland proposes to adjust the remaining two employees' labor costs so that no more than 100 percent of their cumulative time is included in any area of the rate application. The impact of this adjustment is a reduction of $33,236 and $34,664 to CalAm-allocated operating expense in 2008 and 2009, respectively.

14. Co e A o a o o Ca A - We reviewed the distribution of NSC and LSC expenses to CalAm. As discussed below, Overland recommends adjustments to CalAm's test year-requested NSC and LSC allocation factors for CalAm. Our adjustments reduce CalAm's NSC-allocated expense by $716,334 in 2008 and 2009 and reduce LSC-allocated expense by $48,823 in 2008 and $51,000 in 2009. In total, CalAm expense is reduced by $765,157 in 2008 and by $767,334 in the 2009 test year.

NSC Allocations to CalAm - The NSC serves both the regulated and non-regulated segments of American Water. Within the regulated segment AW allocates costs among 20 regulated state-based water companies. AW has two levels of allocation. "Tier 1" factors distribute expense between the regulated and non-regulated segments based on various measures of relative segment size, including revenues, expenses and employees. Tier 2 allocations distribute regulated segments costs (after Tier 1 allocation) among the 20 regulated water companies. Tier 2 allocations are based on customers.[33]

[33] Customers are used only for Tier 2 allocation. They are not used to allocate between the regulated and non-regulated segments. For example, in the regulated water companies a customer is a residential or commercial user of water service. On the non-regulated side, AW may have an operating agreement with a city to perform services for the city's water users. The "customer" in this case is the city, not the residents and businesses that use the city's water service.

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Ca A Pe e age of NSC Ra e g Ca ego A o a o a
A e a ae Reg a e C o e

Rate Filing Category	2006	2007	Test Year per CalAm	Test Year per Overland
Belleville Lab	5.41%	5.42%	5.40%	4.56%
Customer Service Center (1)	5.28%	5.41%	5.42%	4.56%
Finance	4.67%	5.03%	5.16%	4.56%
HR	4.12%	4.37%	4.70%	4.70%
IT	4.92%	5.22%	5.42%	4.56%
NSC Functions (2)	5.93%	5.33%	5.02%	4.56%
Operations / Network	4.34%	4.89%	5.05%	4.56%
Procurement	5.21%	6.89%	6.48%	6.48%
Shared Services	5.62%	6.45%	6.12%	4.56%
Weighted Avg Allocation	5.38%	5.43%	5.41%	4.59%
	2006	2007	2008	
Regulated Customers	5.29%	5.38%	5.18%	5.18%

(1) Included for calculation of weighted average only. Our recommendation for the CSC negates the use of an allocation factor. (2) The common cost pool used for the NSC Functions calculation excludes Northeast, charged to CalAm.

Sources: Allocation Percentages calculated from analysis of OC-52. Customers are from OC-85.

As shown Table 2-4, even with an ostensible allocation to the non-regulated segment, CalAm's test year composite allocation of common NSC expenses (5.41%), is greater than its 2007 year-end share of regulated customers (5.18%). We asked CalAm to support its proposed test year NSC allocation factors. These are shown in the "Test Year per CalAm" column above. CalAm responded:[34]

> Regarding 2008 and 2009 information, there is no "common" cost allocation, as the data for these periods are forecast. The distribution of costs by function is developed based on prior period overall cost assignment experience.

Overland interprets this to mean that there is no calculation support for the test year factors used to distribute NSC costs to CalAm's rate filing. CalAm states that the "distribution of costs" is "based on prior period overall cost assignment experience"; yet, while CalAm's share of regulated customers is *lower* at December 31, 2007 that at the end of 2006, its 2008 share of budgeted NSC expense, based on "prior period overall cost assignment experience," is *higher* than in 2007 and also higher than its share of total regulated customers (even after an ostensible allocation to the non-regulated segment). Our own analysis of historical NSC allocations showed that a significant portion of the NSC's expense was assigned to cost pools that were allocated *only* to the regulated water companies.

[34] Response to OC-51.

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As discussed in Chapter 4, we found that the CSC serves non-regulated customers, but that no CSC expenses are allocated to these non-regulated customers or to the non-regulated business segment. Specifically, we determined that for some time the CSC has provided operating services to municipal water systems for the Township of Edison, NJ and for the City of Elizabeth, NJ (Liberty Water) without allocating any CSC expense to these non-regulated customers. AW acknowledged that it should be allocating expense for "comparable" CSC services to non-regulated customers.[35]

Months after we submitted our data request, AW supplemented its response concerning CSC expense allocations with a list of an additional 104 municipal customers from which AW currently collects $5.7 million for billing services.[36] As with the non-regulated Edison and Liberty contracts, CSC expenses are also not allocated to the 104 municipal customers receiving CSC billing services. In the case of the customers receiving billing services, it appears that AW believes allocations should not be made because the services are not "comparable" to those provided to the regulated segment. Overland notes that AW's opinion and its procedure are inconsistent with fully distributed cost allocation principles required by most regulators.

Calculation of Overland's Recommended NSC Allocation Factors - Overland's recommended allocation of NSC expense to CalAm is simple. For each appropriate rate filing category, NSC expense should be allocated using the following "Tier 1" and "Tier 2" factors:

- Tier 1 NSC Expense Allocation - All NSC expense should be subjected to a reasonable allocation between the regulated and non-regulated segments. This should be based on revenue and expense, measures to which each segment contributes in amounts comparable to the size of its operations.[37] Although AW declined to provided requested non-regulated financial data, AW's 2008 public equity offering required AW to file GAAP-based segment information. From this, we were able to obtain recent regulated and non-regulated revenues and expenses. Overland's recommended regulated non-regulated calculation is summarized in the table below.

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[35] Response to OC-73-C.

[36] Response to OC-210 and attachment.

[37] AW uses relative customers to allocate NSC expense among the regulated water companies. This works because customers are comparable within the regulated segment; that is, customers in each regulated water company consist of thousands of residential and commercial water users. Since Tier 1 and Tier 2 allocations are components of the same cost distribution process, the allocation basis should be consistent to the extent possible (in other words, if customers is the accepted basis, it would ideally be used for both regulated and non-regulated companies, reducing the process to one tier). Unfortunately, AW's regulated and non-regulated customers are not comparable and do not properly reflect the relative size of segment operations. As noted, regulated "customers" consist of millions of residential and commercial water users. On the non-regulated side, "customers" consist of (a few hundred?) water system owners and operators, on average producing a significantly greater amount of revenue than the average regulated customer. The result of combining these two would be a customer ratio not reflective of relative segment size, and therefore not reasonable for use as an "unattributable" allocator ("unattributable" is what all of AW's size-based allocators are).

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Segment	Revenue Amount	Revenue Percent	Expense Amount	Expense Percent	Average Percentage
Regulated	$ 1,987,565	89.12%	$ 1,490,794	86.86%	87.99%
Non-Regulated	242,678	10.88%	225,600	13.14%	12.01%
T	30 43	100.00	1 163 4	100.00	100.00

Source: American Water Form 424B3, Filed 5/12/2008, Segment Information, pp. F35 & F36
Amounts are from Year Ended December 31, 2007

- <u>Tier 2 NSC Expense Allocation</u> - AW allocates the NSC's regulated segment expense among its regulated water companies based on customers. Although customers is a relatively blunt method for allocating all regulated NSC expense, Overland did not have the resources or the time to conduct a detailed review of or redesign the process. Although we concur with AW's use of customers, we note that the test year factors should be based on the most recently available, accurate customer counts. Using year-end 2007 counts, CalAm's customers are 5.18% of total regulated customers.

Overland's recommended test year allocation to CalAm, applicable to most of the NSC rate filing categories, is 4.56%, as summarized below.

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Component	Percentage	Basis
1. Regulated Share	87.99%	Regulated average pct. of combined segment revenue & expense
2. California Jurisdictional Share	5.18%	CalAm percent of of total regulated customers
3. CalAm Regulated Allocation	4.56%	Line 1 x Line 2

Source: American Water Form 424B3, Filed 5/12/2008, pp. F35 & F36
Amounts are from Year Ended December 31, 2007

We recommend a 4.56% allocation for 7 of 9 NSC rate filing categories (6 if the Customer Service Center is limited, as recommended, to 2003 CalAm expense plus inflation). As indicated in Table 2-4 above, we concur with AW's proposed CalAm allocations in the Human Resources function (4.70%) and the Procurement category (6.48%). The allocator for Human Resources is reasonably close to the overall NSC allocator we found to be reasonable (4.56%). Procurement is a unique category. Because a majority of AW's non-regulated operations do not involve the construction of AW-owned plant, we concur with AW's assessment that the Procurement function primarily serves the regulated segment. In recognition of the possibility that construction levels are somewhat higher in California than in other states, and due to the lack of time or resources to perform a detailed analysis, Overland has chosen not to contest the fact that CalAm's proposed test year Procurement factor (6.48%) is 25% higher than CalAm's share of regulated customer (5.18%).

Combining reasonable allocations for each NSC rate filing category results in Overland's recommended weighted average (overall) allocation of 4.59% of common NSC to CalAm, as shown in Table 2-4. The change in allocation factors reduces NSC expense allocated to CalAm by $716,334 in 2008 and 2009.

LSC Allocations to CalAm - Underlying the total charges from the LSC to CalAm are jurisdictional labor cost allocations of 23 employees that are entirely based on projected customer count data. Overland believes actual year-end 2007 customers counts are a more objective basis for the allocation. The adjustment associated with this allocation factor change reduces CalAm ex by $48,823 and $51,000 in 2008 and 2009, respectively. In addition, allocations of non-labor expenses were also affected by the synchronization of labor costs to May 31, 2008 employee levels. The impact of this change is included in adjustment to calculate labor expense based on end-of-May, 2008 employee levels.

Attachment 2-1

General Office Operations and Maintenance Expenses
As Filed By CalAm, Summary of Overland-Recommended Adjustments, As Adjusted by Overland
2008 and 2009 Per CalAm, Overland-Recommended Adjustments, and As Recommended by Overland

2008 Description	As Filed 2008	1. Annualize Labor Expense Based on May 31, 2008 Actual Staff Levels	2. Reduce Incentive Compensation to 2007 Actual Award Levels	3. Remove Business Development Expense	4. Remove Corporate Contributions	5. Remove Legislative Influence Expense	6. Remove Unsupported "Non-Departmental" & "NSC Functions" Expense	7. Correct "Non Departmental" Interest Income and Income Tax	8. Remove Sales and Marketing Expense	9. Limit CSC Expense to 2003 Plus Inflation	10. Remove Unnecessary Payroll Reserve	11. Correct Ommission of Oper Risk Dept Salaries	12. Reverse Allocation Effect of Re-branding LSC Employees as Cal-Corp	13. Remove CalCorp Labor Separately Requested as Rate Case Expense.	14. Correct NSC & LSC Allocations to Cal-Am	Total Adjustments	Adjusted 2008 Totals
Operating Expenses - Dollars:																	
National Service Company																	
Service Company - Belleville Laboratory	302.875	(24.655)	(6,162)	-	-	-	-	-	-	-	-	-	-	-	(42,320)	(73.137)	229.738
Service Company - Call Center	2,802,618	-	-	-	-	-	-	-	-	(831,111)	-	-	-	-	-	(831,111)	1,971,507
Service Company - Finance	581.351	(23.198)	(44,076)	-	-	-	-	-	-	-	-	-	-	-	(59,776)	(127,050)	454,301
Service Company - Human Resources	296,649	(28,306)	(19,204)	-	-	-	-	-	-	-	-	-	-	-	-	(47,509)	249,140
Service Company - Information Technology	1,786,495	(53,939)	(93.007)	-	-	-	-	-	-	-	-	-	-	-	(260,150)	(407,096)	1,379,399
Service Company - "NSC Functions"	1,489,659	139,976	(35,795)	(30,439)	(20,623)	(22,564)	(545,959)	38,195	(72,056)	-	-	-	-	-	(81,524)	(630,790)	856,869
Service Company - Operation / Network	267.594	(11,639)	(50,729)	-	-	-	-	-	-	-	-	-	-	-	(19,913)	(82,282)	185,312
Service Company - Shared Services	1,141,013	(70,099)	(59,540)	-	-	-	-	-	-	-	-	-	-	-	(252,651)	(382,290)	758,723
Service Company - Procurement	152,311	1,926	(19,520)	-	-	-	-	-	-	-	-	-	-	-	-	(17,594)	134,717
Subtotal National Service Company	8.820.565	(69 934)	(328 033)	(30,439)	(20,623)	(22.564)	(545.959)	38,195	(72,056)	(831.111)	-	-	-	-	(716.334)	(2,598,859)	6.221,706
Local Service Company	3,471,949	26,341	(121,159)	(341,030)	-	-	-	-	-	-	(30,050)	-	-	-	(48,823)	(514,721)	2,957,228
California AW GO Function (Cal Corp)	4,768,056	(294,998)	(139.956)	-	-	(188,440)	-	-	-	-	-	-	(321,011)	(33,236)	-	(977,651)	3.790,407
TOTAL	17,060,572	(338,591)	(589,158)	(371,469)	(20,623)	(211,004)	(545,959)	38,195	(72,056)	(831,111)	(30,050)	-	(321,011)	(33,236)	(765,157)	(4,091,231)	12,969,341

2009 Description	As Filed 2009	Annualize Labor Expense Based on May 31, 2008 Actual Staff Levels	2. Reduce Incentive Compensation to 2007 Actual Award Levels	3. Remove Business Development Expense	4. Remove Corporate Contributions	5. Remove Legislative Influence Expense	6. Remove Unsupported "Non-Departmental" & "NSC Functions" Expense	7. Correct "Non Departmental" Interest Income and Income Tax	8. Remove Sales and Marketing Expense	9. Limit CSC Expense to 2003 Plus Inflation	10. Remove Unnecessary Payroll Reserve	11. Correct Ommission of Oper Risk Dept Salaries	12. Reverse Allocation Effect of Re-branding LSC Employees as Cal-Corp	Correct Labor Costs Requested More Than Once	14. Correct NSC & LSC Allocations to Cal-Am	Total Adjustments	Adjusted 2009 Totals
Operating Expenses - Dollars																	
National Service Company																	
Service Company - Belleville Laboratory	302,875	(24,655)	(6,162)	-	-	-	-	-	-	-	-	-	-	-	(42,320)	(73,137)	229,738
Service Company - Call Center	2.802,618	-	-	-	-	-	-	-	-	(831,111)	-	-	-	-	-	(831,111)	1.971,507
Service Company - Finance	581.351	(23.198)	(44,076)	-	-	-	-	-	-	-	-	-	-	-	(59,776)	(127,050)	454,301
Service Company - Human Resources	296,649	(28,306)	(19.204)	-	-	-	-	-	-	-	-	-	-	-	-	(47.509)	249,140
Service Company - Information Technology	1,786,495	(53,939)	(93,007)	-	-	-	-	-	-	-	-	-	-	-	(260,150)	(407,096)	1,379,399
Service Company - "NSC Functions"	1,026,220	139,976	(35,795)	(30,439)	(20,623)	(22,564)	(82.520)	38,195	(72,056)	-	-	-	-	-	(81,524)	(167,351)	858,869
Service Company - Operation / Network	267.594	(11,639)	(50,729)	-	-	-	-	-	-	-	-	-	-	-	(19,913)	(82,282)	185,312
Service Company - Shared Services	1,141,013	(70,099)	(59,540)	-	-	-	-	-	-	-	-	-	-	-	(252,651)	(382,290)	758,723
Service Company - Procurement	152,311	1,926	(19,520)	-	-	-	-	-	-	-	-	-	-	-	-	(17,594)	134,717
Subtotal National Service Company	8,357,126	(69,934)	(328,033)	(30,439)	(20,623)	(22,564)	(82.520)	38,195	(72,056)	(831,111)	-	-	-	-	(716,334)	(2,135,420)	6,221,706
Local Service Company	3,546,988	29,170	(125,515)	(352,746)	-	-	-	-	-	-	(30,801)	83,036	-	-	(51,000)	(447,856)	3,099,132
California AW GO Function (Cal Corp)	4,954,495	(339,407)	(144,998)	-	-	(195,648)	-	-	-	-	-	-	(334,197)	(34,664)	-	(1,048 915)	3.905,580
TOTAL	18,858,609	(380,171)	(598,546)	(383,185)	(20,623)	(218,213)	(82,520)	38,195	(72,056)	(831,111)	(30,801)	83,036	(334,197)	(34,664)	(767,334)	(3,632,190)	13,226,419

3. National Service Company Allocations to CalAm

American Water's National Service Company Allocations to CalAm

Approximately half of CalAm's General Office revenue requirement request consists of allocations from the National Service Company (NSC). The basis for CalAm's test year NSC allocations is summarized below.[1]

Ta e NSC 1
A e a ae Na o a Se e Co a
Ca A Te ea Re e e 008 ge e NSC E e ea A o a o o Ca A

Rate Filing Category	Budgeted Total Spend	Budgeted Amounts Not Allocated	Allocable Management Fee	Cal-Am Management Fee Allocation	CalAm Allocation Percentage
Belleville Lab	$ 5,610,705	$ -	$ 5,610,705	$ 302,877	5.40%
Customer Service Center	51,741,509	51,765	51,689,744	2,802,618	5.42%
Finance	20,839,179	9,577,992	11,261,187	581,348	5.16%
HR	6,457,758	142,202	6,315,556	296,648	4.70%
IT	39,949,862	7,005,708	32,944,154	1,786,496	5.42%
NSC Functions	22,524,749	2,101,012	20,423,737	1,026,224	5.02%
Operations / Network	10,409,267	5,105,618	5,303,649	267,596	5.05%
Procurement	4,495,619	2,146,500	2,349,119	152,312	6.48%
Shared Services	19,846,131	1,214,889	18,631,242	1,141,015	6.12%
To a	181 8 4	34 686	1 4 0 3	8 3 134	.41

Source: CalAm Rate Filing (CalAm Amounts); OC-91 (NSC Total Amounts)

Approximately one third of CalAm's requested NSC revenue requirement is expense from the Customer Service Center (CSC) rate filing category. Because of its size, and because of issues unique to it, we discuss the CSC in a separate chapter. The other rate filing categories that comprise the remaining two-thirds of CalAm's NSC revenue requirement request are discussed below.

NSC Expenses by Rate Filing Category

The NSC's forecasted test year allocation to CalAm is based on the NSC's 2008 budget plan. The NSC budget plan is made up of the sum of the budgets of approximately 85 business units.[2] For the rate filing CalAm classified these business units into nine categories. The rate filing contains one line of cost information for each category, showing the historical and 2008 budget year (test year) NSC management fee allocated to CalAm.

After requesting budget support for the NSC revenue requirement, Overland found that the categories presented in the rate filing did not directly correspond with the organizational categories built into AW's budget and accounting system. We found that some rate filing

[1] Of the amounts in this NSC summary table, only the CalAm-allocated amounts are shown in the rate filing. It took approximately 3 months of discovery effort to obtain the amounts in the other columns in the table.

[2] Business units are the basic control (responsibility) areas in AW's budgeting process.

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categories, such as the CSC, corresponded with an "Office" category in AW's accounting system. Others consisted of business units from various "offices" and "functions" (e.g. "NSC Functions"), or an "office" subset of a particular "function" (e.g., Human Resources, which includes business units in the Human Resources "function", but only for the Corporate "office"). None of this information is documented in the rate filing.

Understanding the relationship between the organizational categories in AW's accounting system; in particular, understanding which business units roll up to the amounts for each rate filing category, is fundamental to reviewing the reasonableness of NSC expense charged to CalAm. There is no information in the rate filing or the filing workpapers supporting the NSC expense CalAm is requesting to recover from California ratepayers. In fact, accounting support for test year NSC expenses charged to CalAm consists entirely of what is in this report, its workpapers, and CalAm's responses to Overland data requests. It required more than three months and several rounds of discovery effort to obtain the underlying business unit budget support for the amounts included in the NSC component of the GO revenue requirement and the organizational information necessary to map the business units to their corresponding categories in the rate filing. It was particularly difficult to obtain complete business unit budget detail for the "NSC Functions" rate filing category.

A summary of CalAm's requested level of NSC expense, before and after CalAm allocations, as requested by CalAm, Overland's recommended adjustments, and as recommended by Overland, is shown in Attachment 3-1.

NSC Belleville Lab

NSC Belleville Lab consists of a single business unit, physically located in Illinois. CalAm requested to include the expense of 36 employees in California rates. As of May 31, 2008 it consisted of 30 employees, including chemists, lab technicians, analysts and clerical employees performing water quality testing and assurance. Belleville Lab staffing is summarized below.

Ta e A 1
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NSC e e e a Ra e g Ca ego e U a S aff g

Dept.	Business Unit No.	Business Unit Desc.	Actual Headcount As Of Dec '05	Dec '06	Dec '07	May '08	May '08 Budget
Belleville Lab	34517	BVLAB-Water Quality	34	32	33	30	36
To a e e e a			34	3	33	30	36
Source: Responses to OC-7, OC-91 & OC-92							

Expense - Belleville Lab expense is summarized in the table below.[3]

[3] For most rate filing categories, it is not possible to compare individual categories of historical expense with the budget, because the budget data was provided on a "total spend" basis, while only the "management fee" portion of total expense was provided for the 2006 and 2007 historical periods. In the case of Belleville Lab, "total spend" and "management fee" were the same in the budget period, and given the nature of the function, it is probable that the same is true for the historical periods. Thus, for this rate filing category, we decided it was reasonable to

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Cost Category	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M	$2,097,224	$2,572,176	$2,846,242
Non-Labor O&M	$ 2,063,623	$1,878,474	$2,035,861
Depreciation	$509,103	$239,516	$601,260
Interest	$156,612	$147,868	$127,356
Belleville Lab Total Spend	$ 4,826,562	$ 4,838,034	$5,610,719
Belleville Non-management Fee	$0	$0	$0
Belleville Managemcnt Fee	$4,826,562	$4,838,034	$5,610,719
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$1.55	$1.47	$1.70

Source: Dollars - OC 1, 8 & 9 and OC-91; Customers per OC-85
(1) For 2006 and 2007, customers are average year end figures per OC-85, for

- Labor expense - The 2008 budget (and the CalAm rate filing) is based on salaries for 36 employees. As of May 31, 2008, the additional budgeted staff was not on the payroll; in fact, staffing decreased from 33 at the end of 2007 to 30 at the end of May, 2008.

- Depreciation expense - Belleville Lab depreciation was significantly lower in 2007 than in 2006, and is significantly higher than 2007 in the budget year. AW indicated that the lower expense in 2007 was due to an error that resulted in the company not recording depreciation expense for the Belleville business unit from June through December, 2007.[4] Although 2008 budgeted depreciation is 18 percent higher than 2006, the California impact of the higher expense (about $5,000) is not enough to warrant additional audit effort.

Allocations to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

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compare individual categories of expense between the budget (test year) and historical periods.

[4] Response to OC-169, part 1.

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Ta e A 3 A e a ae Na o a Se e Co a o a a Ca A P o o e Te ea NSC Ma age e ee e e e a Ra e g Ca ego			
NSC Mgt Fee and Distributions	**Actual 2006**	**Actual 2007**	**Test Yr per CalAm**
NSC Totals:			
Direct Charges	1,502	31,635	
National Allocations	4,824,937	4,806,016	
Regional Allocations	122	385	
To a Ma age e ee	**4 8 6 61**	**4 838 036**	**610 70**
CalAm Cost Distributions:			
Direct Charges	-	2,001	
National Allocations	261,229	260,027	
Regional Allocations	-	-	
Ca A o	**61**	**6 0 7**	**30 877**
Ca A Pe e	**.41**	**.4**	**.40**
Source: Data from OC-52			

In 2007 a majority of Belleville Lab expense other than overhead was distributed only to the regulated water companies using allocation method 10533, described as "CP-All Regulated Water Companies." The California percentage for this allocator, 5.52 percent, was somewhat higher than the California share of other commonly used allocators. Allocation workpapers provided in response to OC-84 and 85 do not describe the basis for allocator 10533.[5] The 2007 Belleville Lab expense distribution shows that very small amounts were allocated to non-regulated subsidiaries such as American Water Enterprises and to water companies that AW runs under non-regulated contracts with municipalities.[6] The composite allocation of 5.40% budgeted for 2008 is similar to the actual composite distribution for 2007 (5.42%), which included virtually no non-regulated allocation.

NSC Belleville Lab Recommendations

1. <u>Labor Expense</u> - Overland recommends test year labor expense based on salaries of 30 employees actually on the payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

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[5] OC-84 and 85 describe the basis for many factors; for example, the basis for calculating one commonly-used factor, method 100003, is revenue, plant and employees (tier 1 - regulated / non-regulated) and customers (tier 2 - regulated utility jurisdictional). No such description is provided in OC-84 or 85 for allocation method 10533.

[6] Response to OC-168. For 2008 AW budgeted a 0.25 percent allocation of Lab to its largest non-regulated subsidiary, American Water Enterprises. It has budgeted an $89 (0.003 percent) allocation to the water contract for the City of Edison, NJ, and a $224 (0.01 percent) allocation to the Liberty water contract for the City of Elizabeth, NJ. On a combined basis, 2008 budgeted allocations from Lab to non-regulated cost objectives appear to be less than one third of one percent of the Lab's budgeted expense.

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2. Expense Allocation to CalAm - Overland recommends that a regulated distribution of Belleville Lab expenses of 88% (non-regulated allocation of 12%). This is based on the average regulated share of 2007 corporate revenues and expenses before consolidations.[7] Overland recommends California jurisdictional regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[8] This results in an overall allocation to CalAm of 88% x 5.18%, or 4.56%.

NSC Customer Service Center

The Customer Service Center is discussed in Chapter 3.

NSC Finance

The NSC Finance rate filing category consists of finance, planning and reporting, compliance (Sarbanes-Oxley), investor relations, income tax and treasury functions. Finance business units and headcount are summarized in the following table. The business units that make up the Finance rate filing category include units in the Corporate "office" of AW's Finance "function."

Ta e N I
A e a a e Na o a Se e Co a
NSC a e Ra e g Ca ego e U a S aff g

Dept.	Business Unit No.	Business Unit Desc.	Actual Headcount As Of Dec '05	Dec '06	Dec '07	May '08	May '08 Budget
SC-CORP Finance	32007	CORP-Finance	10	11	11	11	11
SC-CORP Finance	32017	CORP-Planning & Reporting	12	14	13	13	14
SC-CORP Finance	32027	CORP-Reporting & Compliance	2	3	5	4	7
SC-CORP Finance	32037	CORP-Investor Relations	2	2	2	3	3
SC-CORP Finance	32047	CORP-Income Tax	4	8	12	16	15
SC-CORP Finance	32057	CORP-Treasury	8	10	11	10	9
To a a e			38	48	54	57	59

Source: Responses to OC-7, OC-91 & OC-92

Expense - Finance expense is detailed below.

7 American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

8 Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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NSC a e E e e

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$8,525,150
Non-Labor O&M			$12,314,051
Interest			$0
Finance Total Spend	unknown	unknown	$20,839,201
Finance Non-Management Fee	unknown	unknown	$9,577,992
Finance Management Fee (1)	$21,757,808	$41,093,310	$11,261,209
Customers	3,113,038	3,292,081	3,308,296
Management Fee per Customer, per AW	$6.99	$12.48	$3.40

Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007

(1) In 2006 and 2007 Finance includes a large amount of non-recurring expense associated with Sarbanes-Oxley attributable to the RWE divestiture and public offering.

- Labor Expense - The 2008 budget is based on the salaries of 59 positions. The budgeted increase in labor expense is largely the result of budgeted increases in income tax, treasury and compliance unit headcount.

- Non-Labor O&M and Non-Management Fee - A large portion of Finance non-labor O&M consists of contract services associated with Sarbanes-Oxley. Most of this is related to efforts required as a result of AW's decision to separate itself from its parent company, RWE, and become a public company. These contract services peaked in 2006 and are expected to be non-recurring in the test year. As such, AW removed them from the Finance management fee it requests to recover from California ratepayers. The amounts removed make up most of the budget period "non-management fee" shown in the table above. Finance contract services for the three years ending with the 2008 budget are as follows:

2006 Actual	$16,317,291
2007 Actual	$32,865,640
2008 Budget	$10,715,840

Of the contract services in the 2008 budget, AW included $1,485,140 in the management fee to be allocated to CalAm and other cost objectives.

Allocations to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

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Ta e N3 A e a ae Na o a Se e Co a o a a Ca A P o o e Te ea NSC Ma age e ee a e Ra e g Ca ego			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	307,081	154,665	
National Allocations	21,900,379	41,315,470	
Subtract: Sarbox	13,684,387	31,812,944	
Adjusted Nat'l Allocation	8,215,992	9,502,526	
Regional Allocations	9,980	12,692	
To a Ma age e ee	**8 533 053**	**9 669 883**	**11 61 187**
CalAm Cost Distributions:			
Direct Charges	5,089	(10)	
National Allocations	1,023,713	2,039,865	
Subtract: Sarbox	632,219	1,555,652	
Adjusted Nat'l Allocation	391,494	484,213	
Regional Allocations	1,682	1,821	
Ca A o	**398 .64**	**486 0 3**	**581 348**
Ca A Pe e	**4.67**	**5.03**	**5.16**
Source: Data from OC-52			

The 2008 budgeted allocation is a composite factor.[9] A majority of 2007 Finance expenses, excluding overhead, were allocated with the following methods:

Formula #	Formula Description	CalAm Pct
100001 Total	CP-ALL REGULATED CO'S (W & WW)	5.18%
100003 Total	CP-PLANT/REV/EMPLOY W/O CHILE	4.85%

Slightly less than half of 2008 Finance expense other than overhead was distributed only to the regulated water companies using allocation method 100001. Slightly more than half of the non-overhead expense was distributed using method 100003. Method 100003 results in a lower California allocation because it includes a Tier 1 allocation to the non-regulated segment. Overheads, allocated based on direct labor in each physical location, made up most of the remaining 2007 expense allocation. CalAm's allocated share of Finance overhead expense was slightly more than 5% in 2007.

NSC Finance Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 57 employees actually on the payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid

[9] AW was unable to break composite budget period allocation factors into the separate components (individual cost pools and allocation methods) that make up the composite.

in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - Finance is a corporate function serving the entire American Water structure. As such, a majority of its expenses should not be withheld from distribution to the non-regulated segment as was done in 2007.[10] We do not know how the 2008 composite allocator was developed because there is no supporting calculation. However, CalAm's 2008 allocation percentage is higher than 2007, so it is reasonable to assume that a significant share of 2008 expense is withheld from allocation to the non-regulated segment in the 2008 composite factor.

   Overland recommends CalAm's allocation of NSC Finance expense reflect both a Tier 1 allocation to the non-regulated segment and a Tier 2 jurisdiction regulated allocation based on CalAm's year-end 2007 share of customers, 5.18%.[11] Overland recommends the test year regulated / non-regulated (Tier 1) distribution of Finance based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[12] Overland recommends test year California jurisdictional (Tier 2) regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007. This results in an overall allocation to CalAm calculated as follows: 88% x 5.18% = 4.56%.

NSC Human Resources

This rate filing category consists of business units in the Corporate "office" of AW's Human Resources "function." Additional Human Resources business units, from the Customer Service Center "office," are included in the Customer Service Center rate filing category, discussed above.

[10] A relatively insignificant $168,000 (0.4% of $41.5 million) of finance expense was directly charged to non-regulated subsidiaries in 2007.

[11] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

[12] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

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Ta e R1 A e a ae Na o a Se e Co a NSC a Re o e Ra e g Ca ego e U a S aff g							
	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-CORP Human Resources	32002	CORP-HR Comp/Benefits	3	3	5	5	5
SC-CORP Human Resources	32003	CORP-HR Talent Development	4	3	1	1	2
SC-CORP Human Resources	32004	CORP-HR Labor Relations		2	2	2	2
SC-CORP Human Resources	32006	CORP-Business Center HR	6	5	5	5	7
SC-CORP Human Resources	32013	CORP-HR Systems & Processes	2	2	2	2	2
SC-CORP Human Resources	32014	CORP-Benefits Service Center	13	15	14	13	16
SC-CORP Human Resources	32018	CORP-Human Resources	2	2	2	2	2
To a a Re o e			30	3	31	30	36
Source: Responses to OC-7, OC-91 & OC-92							

Expense - NSC Human Resources expense is summarized in the following table:

Ta e R A e a ae Na o a Se e Co a NSC a Re o e E e e			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$4,164,007
Non-Labor O&M			$2,293,756
Human Resources Total Spend	unknown	unknown	$6,457,763
Human Resources Non-Mgt Fee	unknown	unknown	$142,202
Human Resources Management Fee	$5,375,713	$6,035,312	$6,315,561
Customers	3,113,038	3,292,081	3,308,296
Management Fee per Customer, per AW	$1.73	$1.83	$1.91
Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007			

- Labor Expense - The 2008 budget and the CalAm rate filing are based on salaries for 36 Human Resources employees. Midway through the budget period, staffing has not increased to 36; in fact, headcount decreased from 31 at the end of 2007 to 30 at the end of May, 2008. As discussed below, Overland recommends allocating test year NSC labor expense to CalAm based on *actual* headcount and salaries as of May 31, 2008.

- Non-Labor Expense - 2008 budgeted non-labor costs consist primarily of contract services, software licensing and employee expenses. Mid-way through the budget year, AW is on track to spend approximately what it budgeted for 2008.[13]

Allocation to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

[13] Response to OC-109, OC-109 Attachment, update to data provided in OC-1, 8 & 9

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T R 3
A N S C
C A P T NSC M
R R C

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	618,040	508,924	
National Allocations	4,653,498	5,439,576	
Regional Allocations	105,196	86,812	
T M	**3 6 34**	**6 03 311**	**6 31**
CalAm Cost Distributions:			
Direct Charges	-	-	
National Allocations	221,012	263,217	
Regional Allocations	245	400	
C A	**1**	**63 61**	**6 648**
C A P	**4.1**	**4.3**	**4. 0**
Source: Data from OC-52			

In 2007 about two-thirds of Corporate Human Resources was subject to a Tier 1 allocation between regulated and non-regulated segments (86% regulated / 14% non-regulated) using relative employees (allocation method 100008 - CP - Employees) and among regulated companies using customers.[14] One fourth was allocated only to the regulated water subsidiaries using customers (100001 - CP All Regulated Water Companies W & WW).[15] Most of the remainder was overhead allocated using a labor-based methodology. As shown above, CalAm's 2008 budgeted Corporate Human Resources allocation (4.7%) is higher than 2007 (4.37%). The 2008 factor is a composite; AW does not have a calculation breaking it down into its components.

NSC Human Resources Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 30 employees actually on the payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - We do not know how the 2008 composite allocator was developed because there is no supporting calculation, but it appears that a smaller non-

[14] Data from response to OC-52; factors from responses to OC-84 & 85.

[15] Ibid.

regulated (Tier 1) employee percentage (7.5% in 2008 vs. nearly 14% in 2007) may translate to a higher regulated, and therefore higher CalAm percentage in 2008.[16]

The Corporate office of AW's Human Resources function serves the entire American Water structure. Overland therefore recommends that test year Corporate Human Resource expense be allocated between regulated and non-regulated segments based on relative employee levels, consistent with the methodology AW used for about a majority of the expense in 2007. The regulated Tier 1 employee factor (method 100008) being used for 2008 allocations is 92.5%.[17]

Overland recommends California jurisdictional (Tier 2) regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[18] This results in an allocation to CalAm of 92.50% x 5.18%, or 4.79%. This is close enough to the composite 2008 factor being used by CalAm (4.70%) that we do not propose to adjust CalAm's requested test year allocation factor.

NSC Information Technology

The NSC Information Technology (IT) rate filing category includes a large number business units, primarily in the Corporate "office", performing administration, maintenance and development of AW's computer and information systems. IT accounts for approximately 15 percent of the NSC employees allocated to CalAm customers in this rate filing.

[16] Responses to OC-84 and 85.

[17] Response to OC-85, Tier 1 Formulas, factor inputs as of 12/31/2007.

[18] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

Chapter 3

Ta e T 1
A e a ae Na o a Se e Co a
NSC fo Te o og Ra e g Ca ego e U a S aff g

	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-ITS Location	032030	CORP-ITS Client Rel Admin	1	1	0	1	3
SC-ITS Location	032031	CORP-Service Desk	7	8	8	9	11
SC-ITS Location	032032	CORP-ITS Bus Development	4	5	5	5	5
SC-ITS Location	032033	Chg Ctrl & Desktop Automatior	2	3	3	3	3
SC-ITS Location	032034	CORP-ITS Appl Adm & Security	6	6	5	6	7
SC-ITS Location	032071	CORP-ITS Admin	2	3	3	3	4
SC-ITS Location	032072	CORP-ITS PMO	10	9	9	11	11
SC-ITS Location	032073	CORP-ITS Infra/Oper Admin	2	2	2	2	2
SC-ITS Location	032074	CORP-ITS Production	10	9	9	9	9
SC-ITS Location	032075	CORP-System Maint & Perf	8	11	14	14	19
SC-ITS Location	032076	CORP-Communications	6	6	8	6	8
SC-ITS Location	032077	CORP-ITS Telecom	1	0	0	0	0
SC-ITS Location	032078	CORP-Adm Business Solutions	3	3	3	4	1
SC-ITS Location	032079	CORP-Technical Applications	15	18	22	21	27
SC-ITS Location	032080	CORP-Functional Applications	11	11	16	15	19
SC-ITS Location	032081	CORP-ITS Quality Assurance	4	6	8	6	8
SC-ITS Location	032082	Client Relationship Managemen	1	1	1	3	2
SC-ITS Location	032083	CORP-ITS Strategy/Governance	0	1	0	1	1
SC-ITS Location	032093	CORP-ITS Design Authority	1	1	4	8	6
SC-ITS Location	033031	WE-ITS Client Relations	2	0	0	0	0
SC-ITS Location	033531	CE-Western CS & S	14	0	17	17	18
SC-ITS Location	035031	SE-ITS Client Relations	1	15	0	0	0
SC-ITS Location	036531	NE-Eastern CS & S	16	20	21	21	21
To a fo a o Te o og			1 7	13	158	165	185
Source: Responses to OC-7, OC-91 & OC-92							

Expense - IT expense is summarized in the table below:

Ta e T
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NSC fo a o Te o og E e e

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$21,206,376
Non-Labor O&M			$9,619,873
Depreciation			$8,695,908
Interest			$427,764
Information Technology Total Spend	unknown	unknown	$39,949,921
Information Technology Non-Mgt Fee	unknown	unknown	$7,005,708
Information Technology Management Fee	$29,036,711	$30,245,524	$32,944,213
Customers	3,113,038	3,292,081	3,308,296
Management Fee per Customer, per AW	$9.33	$9.19	$9.96
Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007			

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- Labor Expense and Vacancies - CalAm's test year IT labor expense is based on a 2008 labor budget for 185 positions. AW built vacancy adjustments into the labor budgets of some of IT business units, reducing labor and labor-related costs by approximately $1.4 million (the expense equivalent of about 12 employees). After vacancy adjustments, CalAm is asking California ratepayers to fund the salaries of approximately 173 NSC IT employees. Approximately mid-way through the 2008 budget year, the business units in the IT rate filing category had a headcount of 165 employees, about eight fewer than CalAm is requesting (after vacancy allowances). In other words, at a point near the middle of the budget year, AW's budgeted vacancy allowance captures approximately 60 percent of the budget savings created by actual IT vacancies. As discussed under the heading test year adjustments, Overland recommends test year NSC IT labor expense allocated to CalAm based on 165 employees actually on the payroll as of May 31, 2008.

Allocation to CalAm - The table below summarizes allocations to CalAm in 2006 and 2007, and budgeted for 2008. The 2008 budget is the amount CalAm is requesting in its rate filing.

T T 3
A N S C
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T R C

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	3,970,693	2,625,547	
National Allocations	23,819,777	26,803,704	
Regional Allocations	1,246,210	815,385	
T M	**036 680**	**30 44 63**	**3 44 1 6**
CalAm Cost Distributions:			
Direct Charges	147,535	110,578	
National Allocations	1,186,522	1,372,603	
Regional Allocations	93,367	95,622	
C A	**1 4 4 4**	**1 8 803**	**1 86 4 6**
C A P	**4.**	**.**	**.4**

Source: Data from OC-52, Rate Filing category amounts based on Overland analysis

As shown in the table above, CalAm is proposing to increase its share of IT expense from 5.22% in 2007 to 5.42% in the test year (based on the 2008 budget). As noted throughout this report, 2008 allocation factors are composites for which AW does not have calculation support.

In 2007, approximately $110,000 in IT expense was directly charged to CalAm and approximately $95,000 was the result of regional allocations. Of the $1.4 million allocated nationally, slightly more than half was allocated using method 100001 - CP All Regulated Cos - W& WW. Method 100001 is a Tier 2-only allocation, distributing costs only among the regulated subsidiaries based on customers. CalAm's 2007 percentage under method 100001 was 5.18 percent. Most of the remaining nationally allocated cost consisted of overhead, of which

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4.8% was allocated to CalAm. There was virtually no allocation of Corporate IT to the non-regulated segment. A relatively insignificant $805,000 (2.7% of $30,245,000 in total distributions) was directly charged to non-regulated subsidiaries.

NSC Information Technology Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of 165 employees actually on AW's payroll mid-way through the budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - IT is a corporate function serving the entire American Water structure. As such, we cannot conclude that its expense, apart from relatively minor directly charged amounts, should be withheld from distribution to the non-regulated segment as was done in 2007.[19] We do not know how the 5.42% 2008 composite factor for CalAm was developed because there is no supporting calculation. However, CalAm's 2008 allocation percentage is higher than 2007, so it is reasonable to assume that most of the IT expense in the 2008 budget (and the rate filing) comes from allocation pools charged only to the water companies in the regulated segment.

   Overland recommends CalAm's Corporate IT allocation reflect both a Tier 1 regulated / non-regulated segment allocation and a Tier 2 jurisdictional allocation based on CalAm's year-end 2007 share of regulated customers, 5.18%.[20] As with other NC expense categories, we recommend the regulated / non-regulated distribution be based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[21] Overland recommends California jurisdictional (Tier 2) regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007. This results in an overall recommended allocation to CalAm calculated as follows: 88% x 5.18% = 4.56%.

NSC Functions

The NSC Functions category includes corporate audit, legal, external affairs and regulatory functions. It also includes corporate facilities expenses. Business units and employees are summarized below.

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[19] A relatively insignificant $168,000 in corporate finance was directly charged to non-regulated subsidiaries in 2007.

[20] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

[21] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

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NSC NSC o Ra e g Ca ego e U a S aff g

Dept.	Business Unit No.	Business Unit Desc.	Actual Headcount As Of Dec '05	Dec '06	Dec '07	May '08	May '08 Budget
Audit	32060	Corp - Audit	8	11	8	8	10
Business Developmen	32020	Corp - Business Development	8	5	6	5	5
External Affairs	32022	Corp - Government Affairs	1	1	1	1	1
External Affairs	32025	Corp - External Affairs	1	2	2	2	2
External Affairs	32068	Corp - Marketing / Sales	1	5	5	4	4
External Affairs	32085	Corp - External Communication	1	1	4	2	3
External Affairs	32086	Corp - Internal Communications	3	2	2	2	2
Legal	32015	Corp Legal	8	9	10	11	11
Building & Property	32062	Corp - Buidling Services	6	5	6	5	5
Building & Property	32063	Corp - Bldg Services - Woodcre	3	3	5	5	5
Regulatory	32069	Regulatory UFS	2	2	1	2	2
Non-Departmental	32098	Non-Departmental	?	?	?	1	1
To a			4	46	0	48	1

Source: Responses to OC-7, OC-91 & OC-92

It took a significant discovery effort just to determine the business units that make up the NSC Functions rate filing category. As discussed below, Overland recommends that much of the cost in several NSC Functions business units be removed from CalAm's revenue requirement.

<u>Expense</u> - NSC Functions test year expense (based on the 2008 budget) is summarized below.

Ta e NSC
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NSC NSC o E e e 1

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$6,808,644
Non-Labor O&M			$12,138,517
Depreciation			$1,720,768
Interest			$976,991
Income Tax			$879,828
NSC Functions Total Spend	unknown	unknown	$22,524,748
NSC Functions Non-Management Fee	unknown	unknown	$2,101,011
NSC Functions Management Fee	$ 65,064,964	$ 29,024,093	$20,423,737
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$20.90	$8.82	$6.17

Source: Dollars - OC 1, 8 & 9 (2006 & 2007) OC-91 (2008); Customers OC-85 (Year-end 2007)

(1) Cal-Am included regional expenses in the NSC Functions category. Only an incidental amount (about $50,000) of regional expenses is charged to Cal-Am. As such, Overland excluded regional expenses from this table, as they only serve to distort the calculation of management fee per customer.

Unlike other rate filing categories, we cannot readily compare the 2008 budget for NSC Functions with 2006 and 2007 costs because AW did not provide actual expense data on a business unit basis. The "office" and "function"-based actual and budget data provided in response to OC 1, 8 and 9 contained a number of mis-classifications, and were skewed upward on a pre-allocation basis by expenses from the Central, Southeast and Northeast regions which charged only incidental amounts to CalAm and are not included in test year allocations to CalAm.[22] After considerable effort to reconcile "office" and "function" based data from OC 1, 8 and 9 with business unit budget data ultimately obtained in responses to OC-91 and OC-128, we are confident that the business units included in the test year NSC Functions allocations are accurately reflected in the amounts in the tables above. However, because our ability to reconcile was limited to 2008 data, we cannot compare the 2008 budget detail to 2006 or 2007 actual expense detail.

- Labor Expense - The 2008 budget and the CalAm rate filing are based on salaries for 51 Human Resources employees. As discussed under the heading test year adjustments, Overland recommends NSC labor expense allocated to CalAm based on *actual* headcount of 48 employees as of May 31, 2008.

- Labor Expense Vacancy Adjustment - Embedded in the labor budget for the Non-Departmental business unit is a "global vacancy adjustment" that removes $3,764,000 from the 2008 labor budget to account for vacancies in positions budgeted but not filled during the budget period. CalAm's share of this adjustment is 5.5%, or a reduction of approximately $207,000. AW built separate vacancy adjustments into the Information Technology and Shared Services Center office labor budgets. The vacancy adjustment in the NSC Functions Non-Departmental unit contains the vacancies associated with the business units in other rate filing categories (Finance, Belleville Lab, Human Resources, etc.).

- Non-Labor Expense - Like labor expense, NSC Functions non-labor includes expense associated with legislative influence activities, corporate charitable contributions and certain other expenses that Overland recommends not be funded by California ratepayers. Adjustments to these items are discussed elsewhere. Non-labor expense also includes a $1 million "risk reserve for EW" in the Non-Departmental business unit's budget. When we asked about this, CalAm stated that the California allocation was a contingent expense for earthquakes.[23] Overland also recommends removing this made-up expense from the California revenue requirement.

- Interest Income - Offsetting recorded interest expense, which is largely associated with capital leases on property, is $2.4 million in interest income associated with NSC cash

[22] According to the reconciliation obtained in response to OC-107, NSC Functions data provided in response to OC 1, 8 and 9 excluded Business Development business unit 32020, excluded Corporate Social Responsibility business unit 32087, and included business unit 32019, Corporate Operational Risk. The NSC Functions data provided in OC 1-8-9 was skewed high by the inclusion of more than $53 million in Central, Northeast and Southeast Region expense. Only a small amount of the regional-source expense was charged to CalAm.

[23] Response to OC-162.

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balances included in the "Non-Departmental" business unit. AW stated that interest income (which reduces requested expense) was over-estimated when budgeted in 2007, and will be only about $1 million, rather than $2.4 million for 2008.[24] As discussed below, Overland recommends accepting AW's updated, lower estimate of interest income.

- Income Tax Expense - AW stated that $880,000 in income tax expense included in the "Non-Departmental" business unit is associated with expense that is not deductible for tax purposes, primarily non-deductible business meals.[25] There is not nearly enough non-deductible meal expense budgeted in 2008 in the business units allocable to CalAm to account for the income tax expense. AW offered a new, lower calculation of income tax based primarily on $546,000 in non-deductible meals and $12,000 in non-deductible dues. However, the actual amount budgeted in 2008 for non-deductible meals is $334,275.

- Non-Management Fee - Nearly all of the NSC Functions non-management fee is associated with capitalized "locational overhead" expenses. As discussed above, it was not possible within the scope of this audit to perform a review of the NSC's capitalization policies and procedures.

Allocation to CalAm - The table below summarizes "NSC Functions" expense allocated to CalAm by AW's Corporate Office.[26] The 2008 budget percentage is the composite percentage CalAm is requesting for this rate filing category.

[24] Response to OC-191.

[25] Id.

[26] 2006 and 2007 GO expense data provided to Overland for the "NSC Functions" rate filing category contained large amounts of expense incurred by the Central, Northeast and Southeast regional "offices," small amounts of which were charged to CalAm in 2006 and 2007. Regional office expense was not included in 2008 budgeted amounts. To improve the comparability of historical and budgeted expense in the table, we removed expense incurred and allocated by "regional" offices. Note that there are still "regional allocations." These are Corporate expenses allocated *to* the regulated water companies in a region (in this case, the Western Region); they are not expenses incurred *by* the regional offices, which, as noted, have been removed.

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Ta e NSC 3
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o a Ca A P o o e Te ea NSC Ma age e ee
NSC o Ra e g Ca ego Co o a e Off e O

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Total			
Direct Charges	23,242,351	1,890,480	
National Allocations	40,869,866	26,975,861	
Regional Allocations	952,747	157,751	
To a Ma age e ee	**6 064 64**	**2 024 0 3**	**20 423 828**
CalAm Distributions:			
Direct Charges	1,778,786	82,100	
National Allocations	2,002,473	1,419,639	
Regional Allocations	79,278	46,601	
Ca A o	**3 860 38**	**1 48 341**	**1 026 224**
Ca A Pe e	**. 3**	**.33**	**.02**
Source: Data from OC-52			

To improve the comparability of historical and budgeted amounts, we removed expense incurred by the Central, Southeast and Northeast regional "offices" from the 2006 and 2007 historical data summarized above, leaving only the historical expenses from the Corporate office. As far as we can determine, 2008 budget expense for NSC Functions does not contain any expense incurred by regional offices. Even with regional expense removed, there are significant differences between historical and budgeted allocations to CalAm. For example, in the historical periods, large amounts of expense were directly charged to CalAm, skewing CalAm's composite distribution above what would be expected.

Overland was unable to obtain comparable historical data on a business unit basis, so we do not know what "NSC Functions" business units directly charged large amounts to CalAm in 2006 and 2007. It is likely that 2006 and 2007 expenses are based on a different set of business units than the budget period. Therefore, for this category, even with regional amounts removed from the historical columns, it probably does not make sense to compare budgeted and historical CalAm expense allocations, either in total or on a percentage basis. As discussed below, Overland believes that CalAm's share of allocable expense should reflect 1) the regulated segment's share of total corporate revenue and expense and 2) CalAm's share of total regulated customers.

NSC Functions Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on salaries of employees actually on AW's payroll mid-way through the 2008 budget year. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

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2. Labor Expense Vacancy Adjustments - Consistent with our recommendation to base test year labor expense on actual employee levels mid-way through the budget period, Overland recommends reversing AW's budgeted "global vacancy adjustment", adding back the amounts removed for vacancies in other rate filing categories.

3. Non-Recoverable Expenses - Overland recommends removing the following expenses included in NSC Functions from allocation to CalAm ratepayers. These expenses have either been disallowed by the Commission in prior CalAm rate case decisions, have been traditionally allocated to ratepayers in California utility rate proceedings, or benefits to regulated water utility customers are not supported.

   - Business development expenses (Business Development business unit 32020)
   - Legislative influence expenses (Government Affairs business unit 32022)
   - Charitable contributions (Corporate Social Responsibility business unit 32087 and account 575140 - Charitable Contributions)
   - Unsupported "Non-Departmental" business unit expense, which includes a $1 million unsupported contingent risk expense and $446,000 in expense for a non-departmental employee whose responsibilities AW declined to disclose
   - Marketing and sales expense (business unit 32068)

4. Adjustment to Interest Income - Based on a decline in interest rates since 2007, Overland recommends recognizing lower interest income on NSC cash balances, as calculated by CalAm. AW's updated calculation is based on actual 2008 interest income through June, which totals $508,000. Overland agrees that interest income should be adjusted to reflect an updated estimate of likely income for the budget year. The updated test year estimate of $1,016,000 requires an adjustment reducing the original 2008 budget estimate by $1,427,200.

5. Adjustment to Federal Income Tax - Overland recommends that federal income tax expense on non-deductible expenses be limited to the non-deductible expense actually budgeted in 2008. Non-deductible meals are budgeted at $334,275. Other items included in AW's income tax expense calculation total $12,973.[27] Using AW's tax rate of 35%, federal income tax on these amounts is $121,537. This is a reduction of $758,291 from AW's test year income tax on non-deductible items estimate of $879,828.

6. Expense Allocation to CalAm - NSC Functions contains the corporate audit, external affairs and legal business units. It also includes the corporate facilities expense. The business units in this rate filing category serve the entire corporate structure. Overland recommends CalAm's allocation of NSC Functions include a Tier 1 regulated / non-regulated segment allocation, based on relative regulated and non-regulated revenue and expense and a Tier 2 jurisdictional allocation based on CalAm's year-end 2007 share of regulated customers. As with other NSC expense categories, we recommend the regulated / non-regulated distribution be based on the average regulated and non-

[27] Response to OC-191.

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regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[28] We recommend the California jurisdictional (Tier 2) share of regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[29] This results in an overall recommended allocation to CalAm of 88% x 5.18% = 4.56%.

NSC Operations / Network

The Operations / Network rate filing category includes Chief Operating Officer, operational risk, performance, engineering, asset management and technical services business units. Business units and staffing are summarized below.

Ta e ON 1
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NSC O e a o Ne o Ra e g Ca ego e U a S aff g

Dept.	Business Unit No.	Business Unit Desc.	Actual Headcount As Of Dec '05	Dec '06	Dec '07	May '08	May '08 Budget
SC-CORP Operations	32011	CORP-Chief Operating Officer	4	4	3	3	3
SC-CORP Operations	32019	CORP-Operational Risk	11	10	10	13	15
SC-CORP Operations	32064	CORP-Operational Performance	5	4	4	5	6
SC-CORP Operations	32065	CORP-Asset Management	5	7	8	9	10
SC-CORP Operations	32066	CORP-Research & Env Excellence	12	13	14	16	14
SC-CORP Operations	36550	CORP-COE-Engineering	5	6	8	11	11
SC-CORP Operations	36551	CORP-COE-Technical Services	6	7	8	10	10
To a O e a o Ne o			48	51	55	6	6

Source: Responses to OC-7, OC-91 & OC-92

Expense - Operations / Network expenses, as reported by American Water, are summarized in the following table.

[28] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[29] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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T ON
A N S C
NSC O N E

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$8,925,744
Non-Labor O&M			1,414,565
Depreciation			45,700
Interest			23,258
Operations / Network Total Spend	unknown	unknown	$10,409,267
Operations / Network Non-Mgt Fee	unknown	unknown	$5,105,618
Operations / Network Management Fee	8,201,502	5,759,146	$5,303,649
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer	$2.63	$1.75	$1.60
Source: Dollars - OC 1, 8 & 9 for 2006 & 2007 & OC-91 for 2008; Customers OC-85			

Nearly half of total expenditure in Operations / Network is withheld from allocation in the non-management fee. Most of this consists of capitalized amounts. For example, more than 80% of 2008 budgeted total spend for the Asset Management business unit is budgeted for capital. Time constraints prevented a review of the breakdown between capital and expense.

Expense Allocation to CalAm - The table below summarizes NSC Functions allocations to CalAm in 2006 and 2007, and budgeted by AW for 2008. The 2008 budget percentage CalAm requests for assignment to California ratepayers, 5.05%, is 16% higher than the percentage allocated in 2006 (4.34%), and 3% higher than the 2007 percentage.

T ON 3
A N S C
C A P T NSC M
O N R C

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	2,839,169	539,411	
National Allocations	5,305,658	5,212,131	
Regional Allocations	56,675	7,605	
T M	8 01 0	146	303 64
CalAm Cost Distributions:			
Direct Charges	81,437	28,948	
National Allocations	272,309	252,699	
Regional Allocations	2,161	257	
C A	3 0	81 04	6 6
C A P	4.34	4.8	.0
Source: Data from OC-52			

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CalAm is proposing an increase in its share of expense in the Operations / Network category from 4.3% in 2006 to 5.05% in the test year. As in other rate filing categories, the 2008 budgeted allocation percentage is a composite estimate for which there is no calculation support.

NSC Operations / Network Expense Recommendations

1. Labor Expense - Overland recommends test year labor expense based on the annualized compensation for 67 employees actually on AW's payroll for this rate filing category as of May 31, 2008. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - As with other NSC expense categories, we recommend a regulated / non-regulated (Tier 1) expense distribution based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[30] We recommend the California jurisdictional (Tier 2) share of regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[31] This results in an overall recommended allocation to CalAm of 88% x 5.18% = 4.56%, consistent with the actual composite distribution of 2007 expense.

Shared Services Center

The Shared Services Center (SSC) contains most of AW's corporate accounting and some of its corporate treasury function. Among its business units are one which appears primarily dedicated to the regulated segment (BU 32574 - Rates & Regulation) and one primarily dedicated to the non-regulated segment (BU 32580 - AWE).

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[30] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[31] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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Ta e SSC 1 A e a ae Na o a Se e Co a NSCS a e Se e Ce e Ra e g Ca ego e U a S aff g							
	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-SSC Location	32084	SSC-Accounts Payable	18	26	28	31	29
SC-SSC Location	32505	SSC-Administration	8	10	10	10	11
SC-SSC Location	32560	SSC-Financial Reporting	0	0	0	0	0
SC-SSC Location	32570	SSC-General Accounting	21	32	34	36	38
SC-SSC Location	32571	SSC-Tax	5	9	9	8	10
SC-SSC Location	32572	SSC-Business Support Services	8	8	8	8	10
SC-SSC Location	32574	SSC-Rates & Regulation	10	10	11	11	11
SC-SSC Location	32575	SSC-Cash Management	17	18	18	16	20
SC-SSC Location	32577	SSC-Fixed Assets/Job Cost	15	16	18	18	21
SC-SSC Location	32578	SSC-Project Management	3	2	2	2	3
SC-SSC Location	32579	SSC-Employee Services	23	32	29	29	32
SC-SSC Location	32580	SSC-AWE	7	12	14	10	17
To a S a e Se e Ce e			13	1	181	1	0
Source: Responses to OC-7, OC-91 & OC-92							

Expense - SSC expenses are summarized below.

Ta e SSC A e a ae Na o a Se e Co a NSCS a e Se e Ce e E e e Pe A e a ae			
	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$18,385,787
Non-Labor O&M			$1,455,371
Depreciation			$5,004
Interest			$0
Shared Services Ctr Total Spend	unknown	unknown	$19,846,162
Shared Services Ctr Non-Mgt Fee	unknown	unknown	$1,214,889
Shared Services Ctr Management Fee	$16,792,259	$17,302,697	$18,631,273
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$5.39	$5.26	$5.63
Source: Dollars - OC 1, 8 & 9; Customers OC-85			

- Labor Expense - Test year labor expense is based on a budget that includes compensation for 202 positions. The budget for business unit 32505 - SSC Administration includes vacancies removing $570,000 for the equivalent of 6 positions. Net of vacancies, CalAm is requesting rate recovery for its allocated share of 196 positions (202 minus an allowance of 6 vacancies). As of May 31, 2008, about halfway through the budget year, the SSC had 179 employees, 17 fewer than the positions for which CalAm is requesting funding.

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- <u>Non-Management Fee</u> - A majority of the Operations / Network category's non-management fee consists of the assignment of expense from business unit 32574 - Rates and Regulation to specific rate cases. About half of the Rates and Regulation budget is assigned to specific rate cases.

<u>Expense Allocation to CalAm</u> - The table below summarizes AW's allocation of the SSC management fee to CalAm.

T SSC 3
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C A P T NSC M
S S C R C

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
<u>NSC Totals:</u>			
Direct Charges	1,093,599	1,822,114	
National Allocations	15,684,516	13,036,638	
Regional Allocations	14,144	2,449,272	
T M	**16 8**	**1 308 0 3**	**18 631 44**
<u>CalAm Cost Distributions:</u>			
Direct Charges	93,192	74,069	
National Allocations	847,683	753,332	
Regional Allocations	2,771	289,127	
C A	**43 64**	**1 116 8**	**1 141 01**
C A P	**.6**	**6.4**	**6.1**
Source: Data from OC-52			

In 2007 AW directly charged and allocated to AWE (American Water Enterprises, the most significant non-regulated subsidiary) an amount approximate to the 2008 budget for business unit 32580 - SSC - AWE. This suggests that the budget period composite factor is based on AWE being charged for business unit 32580, but nothing more from the accounting and treasury functions that should be common to both the regulated and non-regulated segments.

Although lower than the 2007 percentage, the 2008 budget composite factor attributed to CalAm (6.12%) is considerably higher than a Tier 1 allocation using relative revenue and expense and a Tier 2 allocation based on year-end 2007 customers would suggest (4.56%). The components of the 6.12% composite factor CalAm requests for ratepayer funding cannot be directly analyzed, since there is no supporting calculation for it.

SSC Recommendations

1. <u>Labor Expense</u> - Instead of rising from 181 employees at the end of 2007 to 202 employees (196 with AW's vacancy allowance) near the mid-point of the 2008 budget year, SSC headcount has fallen to 179 employees. Overland recommends test year labor expense based on the annualized compensation for 179 employees actually on AW's payroll for this rate filing category as of May 31, 2008. We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and

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middle-management employees for which CalAm supplied copies of its annual incentive plan.

2. Expense Allocation to CalAm - As with other NSC expense categories, we recommend the regulated / non-regulated distribution be based on the average regulated and non-regulated shares of 2007 corporate revenues and expenses before consolidations (88% / 12%).[32] We recommend the California jurisdictional (Tier 2) share of regulated expense based on California's 5.18% share of regulated customers as of December 31, 2007.[33] This results in an overall recommended allocation to CalAm of 88% x 5.18% = 4.56%, consistent with the actual composite distribution of 2007 expense.

NSC Procurement (Supply Chain)

The NSC Procurement, or Supply Chain, rate filing category aligns with AW's Corporate and regional (Western, Central, Southeast and Northeast) Procurement "offices". Business units and staffing are summarized below. Most of the expense is incurred by the Corporate office, which includes a Supply Chain Director, several Managers, Buyers and Procurement Analysts. In addition to the Corporate location, AW's Procurement function maintains a local staff of two (a Manager and an Analyst) in each region.

Ta e PROC 1
A e a ae Na o a Se e Co a
NSC P o e e S C a Ra e g Ca ego e U a S aff g

	Business Unit		Actual Headcount As Of				May '08
Dept.	No.	Desc.	Dec '05	Dec '06	Dec '07	May '08	Budget
SC-Supply Chain Locatior	32010	CORP-Supply Chain-Sourcir	24	27	28	30	29
SC-Supply Chain Locatior	33010	WE-Supply Chain		1	2	2	2
SC-Supply Chain Locatior	33510	CE-Supply Chain	2	2	2	2	2
SC-Supply Chain Locatior	35010	SE-Supply Chain	3	3	2	2	2
SC-Supply Chain Locatior	36510	NE-Supply Chain	3	2	2	2	2
To a S C a			3	3	36	38	37

Source: Responses to OC-7, OC-91 & OC-92

Expense - Procurement expenses are summarized below.

[32] American Water Works Company, Inc., Form 424B3 (Prospectus Filed Pursuant to Rule 424(b)(3), Note 22, Segment Information, pp. F-35 to F-37.

[33] Response to OC-85, Attachment 1, American Water Works Service Company Inc., Customer Counts

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NSC P o e e S C a E e e

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M			$4,068,743
Non-Labor O&M			$426,864
Interest			$0
Procurement Total Spend	unknown	unknown	$4,495,607
Procurement Non-Mgt Fee	unknown	unknown	$2,146,500
Management Fee	$3,705,706	$4,217,506	$2,349,119
Customers	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$1.19	$1.28	$0.71
Source: Dollars - OC 1, 8 & 9; Customers OC-85			

- Labor Expense - Labor and labor related costs have increased in the budget period due to a small increase in staffing, as well as salary inflation (the budget contains 4% across the board salary increases). Procurement is the only rate filing category in which actual headcount as of May 31, 2008 exceeds 2008 budgeted headcount (by one employee). We also recommend limiting incentive compensation to inflation-adjusted amounts actually paid in 2007 to lower and middle-management employees for which CalAm supplied copies of its annual incentive plan.

- Non-Labor Expenses - This consists primarily of employee expenses, insurance and telephone and other office expenses. The decrease from 2006 to 2007 is primarily attributable to a lower contract services.

- Non-Management Fee - About three-fourths of Procurement's budgeted non-management fee represents capitalized expenditures. Overland was not able to conduct a review of the NSC's capitalization procedures.[34] The remainder of the non-management fee is location overhead.

Expense Allocations to CalAm - 2006, 2007 and 2008 budgeted Procurement allocations to CalAm are summarized below.

[34] Capitalization procedures affect the distribution of expenditures between the income statement and the balance sheet. As such, they should be subject to review by the company's external auditors. Our notation that the external auditors should review capitalization procedures should not be understood to mean that we are relying on their review.

Ta e PROC 3
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o a Ca A P o o e Te ea NSC Ma age e ee
P o e e S C a Ra e g Ca ego

NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	24,651	5,651	
National Allocations	3,176,719	3,526,029	
Regional Allocations	504,335	685,825	
To a Ma age e ee	**3 70 706**	**4 17 0**	**349 119**
CalAm Cost Distributions:			
Direct Charges	-	-	
National Allocations	167,058	205,718	
Regional Allocations	25,873	84,728	
Ca A o	**19 931**	**90 446**	**1 31**
Ca A Pe e	**. 1**	**6.89**	**6.48**
Source: Data from OC-52			

In 2007 only about 2 percent of NSC Procurement expenditures were allocated to non-regulated subsidiaries. Although AW's unregulated segment contracts to perform water system operations with municipalities, it does not usually own the facilities it operates.

NSC Procurement Recommendations

1. Labor Expense - Overland recommends test year labor expense based on the annualized compensation for 38 employees actually on AW's payroll for this rate filing category as of May 31, 2008.

2. Expense Allocation to CalAm - Overland was not able to obtain information about the non-regulated segment sufficient to determine whether AW's 2% non-regulated allocation in 2007 was reasonable. However, given what we know about AW's regulated and non-regulated segments, in comparison to other NSC activities it is less likely that the non-regulated segment benefits significantly from Procurement. As such, even though we are not able to directly review the 2008 allocation factor calculation (because there is no supporting calculation), we recognize that it is lower than the 2007 allocation, the components of which we are able to review, and we therefore recommend no adjustment to the CalAm's proposed test year Procurement allocation of 6.48%.

Attachment 3-1

American Water National Service Company
Operations and Maintenance Expense Before and After Allocation to CalAm
2008 and 2009 Per CalAm, Overland-Recommended Adjustments, and As Recommended by Overland

Rate Filing Category	NSC O&M Per American Water, 2008 & 2009	Adjust Labor to May 31, 2008 Actual Headcount	Reduce Budgeted Incentive Pay to 2007 Payout Level	Remove Business Development	Remove Charitable Contributions	Remove Legislative Influence Expense	Remove Unsupported "Non-Dept" Expense	Correct "Non-Dept" Interest Income and Income Tax	Remove Marketing & Sales Expense	Maintain CSC at 2003 Cost per Customer Plus Inflation	Correct NSC Allocation Factors to Include Allocations to Non-Reg	NSC O&M Per Overland, 2008 & 2009
National (Before Allocation)												
Belleville Lab	5,610,705	(458,476)	(114,113)	-	-	-	-	-	-			5,038,116
Customer Service	51,689,744									(15,315,076)		36,374,668
Finance	11,261,187	(444,266)	(854,182)	-	-	-	-	-	-			9,962,738
Human Resources	6,315,557	(606,122)	(408,589)	-	-	-	-	-	-			5,300,845
Information Technology	32,944,154	(978,177)	(1,715,995)	-	-	-	-	-	-			30,249,982
"NSC Functions"	20,423,738	2,177,295	(747,140)	(1,007,903)	(420,021)	(459,562)	(1,445,188)	668,910	(1,467,534)			17,722,594
Operations	5,303,648	(235,239)	(1,004,542)	-	-	-	-	-	-			4,063,868
Shared Services	18,631,242	(1,475,625)	(960,038)	-	-	-	-	-	-			16,195,579
Procurement	2,349,119	31,074	(301,233)	-	-	-	-	-	-			2,078,960
Total NSC	154,529,094	(1,989,537)	(6,105,833)	(1,007,903)	(420,021)	(459,562)	(1,445,188)	668,910	(1,467,534)	(15,315,076)	-	126,987,350
After Allocation to CalAm												
Belleville Lab	302,875	(24,655)	(6,162)	-	-	-	-	-	-		(42,320)	229,738
Customer Service	2,802,618									(831,111)		1,971,507
Finance	581,351	(23,198)	(44,076)	-	-	-	-	-	-		(59,776)	454,301
Human Resources	296,649	(28,306)	(19,204)	-	-	-	-	-	-			249,140
Information Technology	1,786,495	(53,939)	(93,007)	-	-	-	-	-	-		(260,150)	1,379,399
"NSC Functions"	1,026,220	139,976	(35,795)	(30,439)	(20,623)	(22,564)	(82,520)	38,195	(72,056)		(81,524)	858,869
Operations	267,594	(11,639)	(50,729)	-	-	-	-	-	-		(19,913)	185,312
Shared Services	1,141,013	(70,099)	(59,540)	-	-	-	-	-	-		(252,651)	758,723
Procurement	152,311	1,926	(19,520)	-	-	-	-	-	-			134,717
Total Cal-Am	8,357,126	(69,934)	(328,033)	(30,439)	(20,623)	(22,564)	(82,520)	38,195	(72,056)	(831,111)	(716,334)	6,221,706

4. NSC Customer Service Center

The Customer Service Center (CSC) rate filing category accounts for about one-third of CalAm's test year-proposed NSC revenue requirement. It corresponds directly with the Customer Service Center "office" in AW's accounting system. The CSC consists of call centers in Alton, IL and Pensacola, FL. Prior to 2003 CSC functions were performed on a state or regional basis.

The Alton and Pensacola call centers perform call handling (order taking and responses to customer inquiries), customer billing and account collection for regulated AW water systems in 29 states. The CSC also provides non-regulated services to more than 100 municipalities. Expense incurred to provide these services, attributable to non-regulated activities under fully distributed cost principles, is instead allocated to AW's regulated water systems. In addition to call handling, billing and collections, the CSC includes supporting administrative, operations, education / training and human resources functions.

The CSC rate filing category includes more than half of the employees included in the NSC budget charged to CalAm. CSC business units and staffing are summarized below.

T CSC 1
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C S C R C U S

Call Center	Business Unit No.	Business Unit Desc.	Actual Headcount As Of (1) Dec '05	Dec '06	Dec '07	May '08	Budget May '08(1)
Alton	34005	CCA Administration	13	13	12	12	17
Alton	34018	CCA Human Res.	6	5	5	9	6
Alton	34070	CCA Call Handling	170	181	199	231	240
Alton	34071	CCA Billing	120	120	116	118	120
Alton	34072	CCA Collections	39	41	39	39	38
Alton	34073	CCA Operations/ Perf.	13	13	13	13	14
Alton	34074	CCA Business Services	16	15	14	14	17
Alton	34075	CCA Educ/ Developmt	22	19	16	14	14
Alton Subtotal			399	407	414	450	466
Pensacola	37005	CCP Administration	1	3	3	2	3
Pensacola	37018	CCP Human Res.	3	2	2		2
Pensacola	37070	CCP Call Handling	198	246	242	235	269
Pensacola	37071	CCP Billing	1				
Pensacola	37073	CCP Operations Support	5	3	3	3	3
Pensacola	37074	CCP Business Services	1				
Pensacola	37075	CCP Educ/ Developmt	8	7	7	7	7
Pensacola Subtotal			217	261	257	247	284
T C S C			**616**	**668**	**6 1**	**6**	**0**

Source: Responses to OC-7, OC-91 & OC-92

(1) The budget for the Call Handling business unit is seasonal and varies, peaking around June. Actual headcount for May, 2008 is as of May 31. For comparability to May 31 actual headcount, the May, 2008 budgeted headcount for Alton and Pensacola Call Handling in this table are an average of May and June headcounts in the budget.

Call center staffing has a seasonal element. Temporary employees are added as the calendar progresses toward the summer. The budget for December, 2008 shows 42 fewer employees than the May-June, 2008 budget average shown above. Notwithstanding the seasonal element, as shown above, AW had 53 fewer employees on the payroll at the end of May, 2008 than the headcount on which revenue requirement is based.

Expenses

Historical and budgeted CSC operating expenses are summarized below.[1] As the table shows, there is a significant increase in expense per customer between 2006 and 2007 and between 2007 and the test year. Although actual CSC expense per customer has been increasing at a pace significantly higher than inflation since at least 2004, test year expense shown below is also higher by approximately 50 call center staff that had not been hired approximately mid-way through the 2008 budget year.

T CSC
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NSC C S C C E

	2006 Actual	2007 Actual	Test Year Per Cal-Am
Labor & Labor Related O&M	$23,826,223	$29,849,509	$36,124,149
Non-Labor O&M	$11,885,407	$ 12,689,257	$12,917,979
Depreciation	$ 2,249,022	$ 689,319	$1,747,344
Interest	$ 1,400,058	$ 1,248,732	$952,044
Customer Call Center Total Spend (1)	$39,360,710	$44,476,817	$51,741,516
Customer Call Center Non-Mgt Fee			$51,765
Customer Call Center Management Fee	$39,360,710	$44,476,817	$51,689,751
Customers (1)	3,113,038	3,292,081	3,308,296
Mgt Fee per Customer, Per AW	$12.64	$13.51	$15.62

Source: Dollars - OC 1, 8 & 9 and OC-91; Customers OC-85, Year end 2007
(1) Estimated for 2006 and 2007 - assumed management fee = total spend.

Changes in Call Center Operations - In 2003 AW began to transition from local and regional call centers to centers with a national footprint. CalAm's test year includes the expense of two national call centers. National-scope customer services were first deployed in 2003 from the Alton, Illinois call center.[2] Alton performs all of AW's key customer service functions (inbound call handling, billing and collection). For a time Alton handled most or all of the customer service functions for AW's regulated water companies. In 2004 AW made the decision to

[1] For most rate filing categories it is not possible to compare individual historical expense categories with the budget, because the budget data was provided on "total spend" basis, while only the "management fee" portion of total expense was provided for the 2006 and 2007 historical periods. In the case of the CSC rate filing category, "total spend" and "management fee" were nearly the same in the 2008 budget period, and given the nature of the function, it is probable that the same is true for 2006 and 2007. Thus, for this rate filing category, Overland determined it was reasonable to compare individual categories of expense between the budget year and the two most recent historical years.

[2] Interview with Glenn Milton, AW Vice President of Customer Service, June 16, 2008.

implement a second national call center, in Pensacola, FL. Calls were first routed to Pensacola in the third quarter of 2005. The 2008 budget indicates that Pensacola is focused primarily on the call handling function.

<u>Cost Impact of Migrating from a Regional to a National Call Center Model</u> - Centralized operations should enable cost efficiencies to be obtained from economies of scale. Contrary to what normally happens with scale economies, AW's customer service expense per customer increased significantly as AW moved from a local to a national call center model. As far as Overland can determine, this is because the regulated customer base (to which AW apparently allocates *all* CSC costs) has grown at an anemic pace, while CSC costs have grown significantly as the national centers have been deployed. As shown below, CalAm's requested test year CSC expense per customer is nearly 70% higher than expense in 2003, before the first national call center (Alton) was fully deployed. As the table demonstrates, CSC costs have grown far faster than CalAm's regulated customer base.

Ta e CSC 3
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NSCC o e Se e Ca Ce e Ra e g Ca ego
Ma age e ee A o a o o Ca A a e Pe Ca A

Costs to Allocate	Recorded Years					Proposed
	2003	2004	2005	2006	2007	TY 2009
CalAm CSC Allocation	$ 1,653,390	$ 1,848,207	$ 1,892,482	$ 2,077,784	$ 2,404,557	$ 2,802,618
Customers per CalAm	167,834	171,783	171,783	171,824	171,444	172,628
Customers Pct Annual Increase		2.4%	0.0%	0.0%	-0.2%	0.7%
Mgt Fee per Customer	$ 9.85	$ 10.76	$ 11.02	$ 12.09	$ 14.03	$ 16.24
Mgt Fee Pct Annual Increase		9.2%	2.4%	9.8%	16.0%	15.8%

Source: Rate Filing Exh.B, Ch.4, Sec.1, Table 1; Customers per Exh B, Ch 9, Sec.1, Tbl 6 (2003,) & OC-85 (2004-2007)

CalAm's CSC expense per customer progressed upward through the following phases of national call center deployment:

- <u>2003</u> - At some point in 2003, Alton was opened, but it was not fully operational. CalAm's annual cost per customer was $9.61.
- <u>2004 through Second Quarter 2005</u> - The Alton call center became fully operational and CalAm's annual cost per customer increased to just under $11.00.
- <u>Third Quarter 2005 through 2006</u> - The Pensacola call center was added. Common (allocable) costs increased due to an increase in call center staffing that was not matched by a corresponding increase in regulated customers. CSC expense per CalAm customer rose to $12.09 in 2006 as Pensacola became fully staffed.

- 2007 - By December, 2006, combined permanent staffing for Alton and Pensacola stabilized at a headcount of approximately 670.[3] 2007 was the first complete year that both centers were fully staffed. At the end of 2007, staffing remained at about 670. Primarily due to full staffing at Pensacola for a full year, CalAm's CSC expense per customer rose to $14.03 for 2007.

- Test Year (Based on 2008 Budget) - Forecasted expense allocated to CalAm continued to increase in the 2008 budget because of a projected increase of approximately 50 employees over the permanent (non-seasonal) level of about 670 achieved at the end of 2006 and maintained in 2007. Nearly halfway through the budget year, these extra employees have not actually been hired. As of May 31, 2008, headcount was 53 employees under budget. After adjusting for temporary seasonal employees, CSC headcount mid-way through the budget year remained at approximately the same level as year-end 2006. With the added expense of 2008 budgeted employees that have not been hired, test year-forecasted expense rises to $16.24 per Cal Am customer.

The Business Case for Adding Pensacola - Given the apparent lack of cost efficiencies achieved in moving from local centers to the national Alton center, and the additional increase in expense per customer when Pensacola was opened, Overland investigated the decision to add the Pensacola center. A business case covering three options (add the Pensacola center, expand Alton or outsource incremental needs) cited the following items in a page titled "rationale for a second national call center:"[4]

- 23 % increase in the customer base
- Business continuity
- "Quality resource availability" (which could reflect a lack of confidence in Alton's employees or difficulties experienced in dealing with them).

The business case does not say over what period the 23 % increase in customers was realized, but as the table below shows, there has been barely any increase in regulated customers nationally since 2004. For CalAm there has been virtually no increase in customers since Alton's deployment was completed in 2004. CalAm did not contribute the customer growth that helped compel AW to add Pensacola and incur its additional expense, but as the rate filing shows AW clearly expects CalAm to help pay for it.

[3] As shown in table 1, combined staffing was approximately 670 at the end of 2006 and at the end of 2007. The increase of 30 FTEs from December 2007 and May, 2008, to 700, is due to seasonal employment. The remaining additional 50 FTEs have not been hired.

[4] OC-18, American Water Customer Service Center - Dual Center Strategy Report, p.3.

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Dates	AW Total Regulated		California American	
	Customers	Growth Rate	Customers	Growth Rate
12/31/2004	3,193,681		171,783	
12/31/2005	3,249,453	1.7%	171,783	0.0%
12/31/2006 (1)	3,286,944	1.2%	171,824	0.0%
12/31/2007	3,308,296	0.6%	171,444	-0.2%

(1) Adjusted to remove 5,137 customers double counted in Sacramento
Source: OC-85.

<u>Service Quality</u> - Increasing expense per customer (increasing cost, stagnant customer levels) suggests a higher level of customer service. Below is a summary of customer service indicators for AW starting with January, 2003. These statistics run through the period in which national service was deployed in Alton (2003 and 2004) and the addition of Pensacola (late 2005 and 2006). The statistics do not appear to Overland to support a customer service improvement trend commensurate with a nearly 70% increase in expense per customer.

T CSC
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Statistic	Jan-03	Jan-04	Jan-05	Jan-06	Jan-07	Jan-08	May-08
Calls Offered to Queue				328,778	368,417	428,261	357,637
1st Call Effectiveness		91.77%	92.52%	87.13%	75.65%	92.51%	91.45%
% Service Level < 30 seconds	73.85%	72.04%	78.54%	87.40%	63.21%	35.91%	72.76%
% Customer Inquiries Response within 3 days		95.00%	95.50%	90.10%	90.65%	95.98%	94.54%
Avg Speed to Answer (m:s)		:46	:25	:18	1:36	4:07	0:59
Avg Handle Time (min:sec)		5.28	5:14	5:52	5:49	6:04	5:48
IVR Self-Service Calls	11.07%	18.70%	21.54%	NA	NA	NA	NA
Written Correspondence Answered w/in 3 days	100.00%	100.00%	NA	76.41%	88.81%	81.61%	70.65%
Track & Reduce Formal (Com.) Complete		206	171	9	2	555	601
Service Orders Completed as Scheduled	53.02%	95.00%	81.58%	99.48%	98.16%	97.30%	98.66%
Shut Offs Worked as % of Issued	63.43%	54.48%	68.98%	NA	88.82%	65.04%	74.26%
% Unscheduled Est. Readings				1.26%	0.52%	4.43%	1.16%
% Scheduled Est. Readings				-	-	12.30%	12.47%
# Executive Complaints Opened				-	22	53	57

Source: OC-75 and OC-122.

Chapter 4

Service Continuity - Another rationale AW put forward to justify the new Pensacola center is service continuity. To accept service continuity as a reason, it is necessary to accept two premises. First, it is necessary to believe that customer call centers are so vital that service can never be interrupted. Second, it is necessary to accept that AW was not able to insure service continuity by expanding the Alton facility or by building redundancies and protections into it; rather, that service continuity could only be achieved by adding a new center at a separate, distant location.

During our interview with Glenn Milton, AW's Vice President of Customer Service, we were told that it has been necessary on several occasions to shut down the Alton call center.[5] When we requested the statistics, we found the following service interruptions have occurred at Alton in the 4½ year period since January 1, 2004, shortly after the center opened[6]:

July 19, 2006	Alton customer service was off line for 30 minutes due to a tornado warning.
November 30, 2006	The Alton center closed at 3 PM due to a winter storm warning. It reopened the next morning at 10:30 AM.
February 21, 2008	The Alton center closed at 3 PM, again due to a winter storm warning. It reopened at 9 AM the next morning.

To put the service continuity issue into further perspective, it is important to understand that the average American Water customer contacts a call center on an average of between 1.3 and 1.5 times per year.[7] It is also important to understand that water emergencies during the hours that the call centers are not operating are handled locally by each water system. It is not at all obvious to us that reducing a customer service interruption from a rate of less than one percent to zero justifies a 42 % increase in customer service expense.[8]

Non-Regulated CSC Contracts and Customers

AW has contracts with more than 100 municipal customers to provide billing, collection and call handling services. As far as Overland can determine, AW allocates the expense associated with these services to regulated customers while recording the revenues as non-regulated. CSC services provided to non-regulated customers could help explain:

[5] Interview of Glenn Milton, Vice President of Customer Service, June 16, 2008.

[6] OC-106.

[7] OC-18 American Water Customer Service Center - Dual Center Strategy Report, p.4.

[8] 2008 budgeted expense for Pensacola is $15.7 million, about 42% more than the $37.0 million budgeted for Alton.

- Why the Pensacola call center was added in 2005.[9]

- Why, since the time national call center services were first deployed in 2003, CSC expenses allocated to Cal Am have grown significantly faster, on an inflation-adjusted basis, than regulated customers.

<u>"Comparable" CSC Services Provided to Non-Regulated Contracts and Customers</u> - In request OC-19 we asked CalAm to provide a list and copies of all contracts with municipalities and other non-AW systems that used the services of the national call centers. AW responded with a list and copies of the following four contracts:[10]

- Liberty Water (Services to a system owned by the City of Elizabeth, NJ)
- Edison Township, NJ
- City of Surprise, AZ
- Descanco, CA

Based on the wording, it did not appear the response provided a complete list of non-regulated CSC customers and contracts. In OC-71 we asked AW to confirm that it was a complete list, or to amend it and provide a complete list. AW stated that "the list (of four contracts) is a complete list of contracts for service which would include call center services *comparable to* call center services being provided to regulated utility subsidiary customers such as those of California American (emphasis added)."[11]

We also followed up with questions about how call center expenses were identified and charged to these contracts. AW acknowledged that CSC expenses were not allocated to the non-regulated contracts AW considered to be "comparable" to the services provided to CalAm.[12] AW added that it was "currently developing a new formula to apply to the call center costs in 2008."[13]

<u>"Non-Comparable" CSC Services Provided to Non-Regulated Contracts and Customers</u> - It turned out that AW had many more than the four non-regulated contracts listed in response to OC-19. In fact, there are more than 100 contracts under which CSC billing services are provided

[9] Evidence that non-regulated services were a consideration in adding Pensacola can be found in the business case document (OC-18) which cites "[in]ability to 'sell' customer service as a business development opportunity to municipalities" as a "con" under an "outsourcing" option. "Outsourcing" and "Expanding Alton" were options compared with Pensacola in the business case document.

[10] Response to OC-19.

[11] Response to OC-71-A.

[12] Responses to OC-73-C and OC-74-C

[13] Overland notes that there is no evidence of the new formula in the 2008 allocation factor support provided in response to OC-85, nor is it evidenced in CalAm's 2008 budgeted share of CSC expenses (5.42%), which is virtually the same as the 2007 allocation (5.41%), and higher than the 2006 factor of 5.28%. CalAm's proposed test year allocation is higher even though CalAm's share of total customers (the basis for the allocation) has declined since 2006.

to municipalities.[14] A list of the contracts is shown in Attachment 4-1.[15] Currently, the contracts for "non-comparable" services produce about $5.6 million annually in revenue, enough to offset about 12% of the CSC's 2007 operating expenses.

In responding to OC-71-B, AW objected to the follow-up question for a list of *all* non-regulated CSC contracts as "too broad and . . . burdensome."[16] However, AW then proceeded to answer the question as follows:

> There are additionally a significant number of [non-regulated municipal] contracts in which other services are provided which we have since determined could include "services" being provided by the call center to customers of the wastewater system owned and operated by the municipality in which water service is already provided. There are several contracts providing for billing and collection of trash . . . fees, and several contracts providing for billing and collection of stormwater service fees.

AW then indicated its philosophy for assessing whether or not the cost of providing a service should be allocated to a non-regulated contract.

> Our initial determination was that these contracts only provided for adding a line to the bill already being sent to a water customer, and computer services related to applying remittances to the proper municipality for amounts collected, which is all done primarily on the computer system and not involving call center personnel.

The response contains an indication of the possibilities that such services require calls to be handled by the call centers ("conceivable") and service personnel to be dispatched ("not included").

It appears from the discussion in OC-71 that AW's philosophy is that a service, such as customer service, provided to both regulated and non-regulated customers, does not need to be allocated or charged to the non-regulated segment (or below-the-line on the regulated company's books) unless it adds what AW thinks is a significant incremental cost to providing the service.[17] This is directly at odds with Overland's understanding of California affiliate transaction and cost allocation policies, which require a full distribution of all costs benefitting both regulated and non-regulated operations.

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[14] In a supplemental response to OC-71 provided several months after the initial response, AW provided a list of 104 non-regulated municipal customers of the CSC.

[15] Response to OC-210

[16] Response to OC-71-B.

[17] However, even in the cases where the company agrees that services provided to non-regulated customers are "comparable" to those provided to the regulated water systems - as in the case of the Edison and Liberty systems - it still does not actually allocate any cost to the non-regulated customers.

Chapter 4

Expense Allocations to CalAm

Historical recorded and CalAm's test year requested distribution of CSC expense are shown below.

Ta e CSC 6 A e a ae Na o a Se e Co a o a Ca A P o o e Te ea NSC Ma age e ee C o e Se e Ca Ce e Ra e g Ca ego			
NSC Mgt Fee and Distributions	Actual 2006	Actual 2007	Test Year Per CalAm
NSC Totals:			
Direct Charges	1,120,467	750,453	
National Allocations	38,121,655	43,715,739	
Regional Allocations	118,685	6,451	
To a Ma age e ee	**3 360 808**	**44 4 2 643**	**1 68 43**
CalAm Cost Distributions:			
Direct Charges	63,787	55,347	
National Allocations	2,015,206	2,349,188	
Regional Allocations	(348)	22	
Ca A o	**2 0 8 644**	**2 404**	**2 802 618**
Ca A Pe e	.28	.41	.42
Source: Data from OC-52			

Directly Charged Expenses - Direct charges account for 2.3 % of the 2007 and test year customer call center management fee distributed to CalAm.

Nationally Allocated Costs - These are collected and distributed from cost pool 100792, described as "CP Customer Call Center Regulated Companies." and from related benefits (888888) and general (999999) overhead cost pools. The factor used to allocate cost pool 100792 (and related overheads) in the test year was 2006 customers.

CSC Recommendations

1. Test Year Expense - Overland recommends that test year CSC expense charged to CalAm ratepayers be limited to the expense per customer recorded in 2003 (before national call centers were deployed) plus price inflation, as measured by the 2003-2008 change in the consumer price index. Our recommended test year CSC expense charge to CalAm is summarized in the table below.

Chapter 4

Ta e CSC
Ca fo a A e a a e
Ca a o of Te ea Re o e e C o e Se e E e e
a e o 003 Co e C o e P Co e P e f a o T o g e 008

Item	Amount	Source
2003 CSC Expenses, Customers & Cost per Customer		
Estimated Total NSC (@ 5.42% of CalAm)	$ 30,505,351	Calculated (based on 2008 allocation factor)
Cal-Am	$ 1,653,390	Rate Filing, Exhibit B, Chapter 4, Section 1, Table 1
Customers	167,834	Rate Filing, Exhibit B, Chapter 6, Section 1, Tables 3, 4, 5, 6 or 7
C	.8 13	Calculated
Consumer Price Inflation, July, 2003 through July, 2008		
May, 2003	107.6	U.S. Department of Labor, Bureau of Labor Statistics, Consumer Price Index - Chained, Series Id SUUR0000SA0, U.S. City Average, All Items, December 1999 = 100 (http://data.bla.gov/cgi-bin/surveymost)
June, 2008	125.6	
M 003 008	1.16 3	
2008 Inflation-Adjusted CSC Expense		
CalAm	$ 11.4994	Calculated ($9.8513 X 1.1673)
CalAm customers 12/31/2007	171,444	OC-90
C A 008 A C	1 1 0	Calculated
Total NSC Using 5.42% CalAm Allocation	$ 36,374,668	Calculated ($1,969,566 / .0542)

2. Allocation to CalAm - Even if the significantly increased level of CSC expense proposed in the test year is accepted as reasonable, CalAm's proposed test year allocation of CSC expense to CalAm is overstated due to:

   - A double count of 5,137 Sacramento customers in the CalAm customer allocation factor.
   - Failure to update CalAm's allocation for a known and measurable change in customers through the end of 2007 (California's percentage of total customers declined slightly in 2007)
   - A failure to recognize and allocate costs to non-regulated municipal contracts receiving "comparable" and "non-comparable" customer services (customer inquiry, billing and collection). As discussed above, there are more than 100 non-regulated contracts with municipalities.

   Should the Commission determine that test year CSC expenses incurred at the NSC level should be allocated to CalAm (instead of allowing previously-authorized state-level expense adjusted for inflation, as discussed above), we recommend a CalAm allocation of no more than 4.56% (as shown in Chapter 2, Adjustment 14, Table 2-4).

3. Support for Cost Allocations to Non-Regulated Customer Services - With respect to non-regulated services provided by the Customer Service Center, to prevent CalAm from

cross-subsidizing CSC services provided to non-regulated municipal customers, Overland recommends that the Commission require CalAm to credit all revenue from non-regulated CSC revenue sources (part of which is shown in Attachment 4-1) against CSC management fees before the fees are distributed to CalAm.

American Water
Contracts for Billing Services (Water, Sewer, Garbage, Stormwater)

State	District Name	Contract Description
IA	Quad Cities	WW Billing Contract
IL	Chicago Metro - Wheaton Water	WW Billing Contract
IL	ChicagoM - Bolingbrk East-West	WW Billing Contract
IL	Pekin	WW Billing Contract/Garbage
IL	Sterling	WW Billing Contract
IL	Alton	WW Billing Contract/Garbage
IL	Peoria	Garbage Billing
IL	Centerville	WW Billing Contract
IL	E St Louis	WW Billing Contract
IL	Fairmont	WW Billing Contract
IL	Sauget	WW Billing Contract
IL	Saunemin	WW Billing Contract
IL	Shiloh	WW Billing Contract
IN	Newburgh	WW Billing Contract/Stormwater/Garbage
IN	Richmond	WW Billing Contract/Stormwater/Garbage
IN	Summitville	WW Billing Contract
IN	Wabash	WW Billing Contract/Stormwater/Garbage
IN	Farmersburg	WW Billing Contract
IN	New Albany	WW Billing Contract
IN	Porter	WW Billing Contract/Stormwater/Garbage
IN	Sullivan	WW Billing Contract
IN	Terre Haute	WW Billing Contract
IN	Winfield	WW Billing Contract
KY	Lexington	WW Billing Contract/Garbage
MO	Brunswick	WW Billing Contract/Garbage
MO	Jefferson City	WW Billing Contract
MO	Joplin	WW Billing Contract/Garbage
MO	Parkville	WW Billing Contract
MO	St Joseph	WW Billing Contract
MO	Warrensburg	WW Billing Contract
MO	City of Kansas City	WW Billing Contract
WV	Culloden	WW Billing Contract
WV	Advanced Environmental	WW Billing Contract
WV	Barboursville Sanitary Board	WW Billing Contract
WV	Belle	WW Billing Contract
WV	Cabbell Utilities	WW Billing Contract
WV	Chesapeake	WW Billing Contract
WV	Elk Valley PSD	WW Billing Contract
WV	Green Acres	WW Billing Contract
WV	Hinton	WW Billing Contract
WV	Linmont Sanitation	WW Billing Contract
WV	Marmet	WW Billing Contract
WV	N. Putnam PSD	WW Billing Contract
WV	Huntington Sanitary Board	WW Billing Contract
WV	Sewage Systems, Inc	WW Billing Contract
WV	Sissonville PSD	WW Billing Contract
WV	Smithers Sanitary Board	WW Billing Contract
WV	Spring Valley PSD	WW Billing Contract
WV	Town of Clendenin	WW Billing Contract
TN	City of Chattanooga	WW Billing Contract
TN	Hamilton County	WW Billing Contract
TN	City of Red Bank	WW Billing Contract
TN	Rossville, Ga	WW Billing Contract
TN	Ft Oglethorpe, Ga	WW Billing Contract
TN	East Ridge	WW Billing Contract

Contracts for Billing Services (Water, Sewer, Garbage, Stormwater)

Attachment 4-1
Page 2 of 2

State	District Name	Contract Description
TN	Lookout Mountain	WW Billing Contract
TN	Walker City	WW Billing Contract
VA	Alexandria	WW Billing Contract
VA	Hopewell	WW Billing Contract
PA	Borough of Elizabeth	WW Billing Contract
PA	City of Warren	WW Billing Contract
PA	Borough of Greentree	WW Billing Contract
PA	Township of Baldwin	WW Billing Contract
PA	Castle Shannon Borough	WW Billing Contract
PA	Township of South Fayette	WW Billing Contract
PA	Mount Lebanon Municipal	WW Billing Contract
PA	Borough of Carnegie	WW Billing Contract
PA	Borough of Dormont	WW Billing Contract
PA	Borough of Homestead	WW Billing Contract
PA	Borough of Crafton	WW Billing Contract
PA	Cecil Township	WW Billing Contract
PA	Borough of Nescopeck	WW Billing Contract
PA	McDonald Sewage Authority	WW Billing Contract
PA	Wallaceton Boggs Municipal Authority	WW Billing Contract
PA	Collier Township	WW Billing Contract
PA	Yardley Borough	WW Billing Contract
PA	Borough of Ingram	WW Billing Contract
PA	Caln Township	WW Billing Contract
PA	Decatur Township	WW Billing Contract
PA	Borough of Heidelberg	WW Billing Contract
PA	Township of Scott	WW Billing Contract
PA	Borough of Kane	WW Billing Contract
PA	Connoquenessing Borough	WW Billing Contract
PA	Borough of Rosslyn Farms	WW Billing Contract
PA	Borough of Mt Oliver	WW Billing Contract
PA	Borough of Whitaker	WW Billing Contract
PA	City of Clairton	WW Billing Contract
PA	West Homestead	WW Billing Contract
PA	Collier Town Square	WW Billing Contract
PA	Glassport	WW Billing Contract
PA	Thompson	WW Billing Contract
PA	Spring Township	WW Billing Contract
PA	Brentwood	WW Billing Contract
PA	West Hanover	WW Billing Contract
PA	Upper St Clair	WW Billing Contract
PA	Clark Summit	WW Billing Contract
PA	South Franklin Township	WW Billing Contract
PA	Norristown Municipal Authority	WW Billing Contract
PA	Baldwin Borough	WW Billing Contract
PA	Pleasant Hills	WW Billing Contract
PA	Sadsbury	WW Billing Contract
PA	South Coatesville	WW Billing Contract
PA	Bethel Park	WW Billing Contract
PA	Clarion Area Sewer Authority	WW Billing Contract

	2007 Contract Revenue	YTD June 2008 Contract Revenue
Totals	5,508,272.20	2,840,753.28
Annualize 2008		2
2008 Annualized		5,681,506.56

Cal-Am asserts that information
as to the specific contracts is confidential.
Therefore, only totals are indicated.

5. Local Service Company and California Corporate Allocations to CalAm

This chapter discusses the Western Region (Local) Service Company (LSC) and California Corporate General Office (CalCorp). Allocations from these units make up approximately half of CalAm's 2009 test year General Office (GO) operating expense revenue requirement. The table below puts the three components of test year operating expense into context.

Ta e 1 Ca fo a A e a a e Te ea 009 e e a Off e O e a g E e e Se e Co a		
Description	Company Request	% of Total
National Service Company	$8,357,126	49.57%
LSC	3,546,988	21.04%
CalCorp	4,954,495	29.39%
To a	**16 8 8 609**	**100.00**
Source: CalAm Rate Filing (Exhibit B - Chapter 6 - Section 1 - Table 1A), some summing required.		

CalCorp employees typically focus all of their attention on CalAm matters, and therefore charge 100% of their costs to CalAm.[1] LSC employees provide support services to American Water subsidiaries throughout AW's Western Region, which includes California, Arizona, Hawaii, New Mexico, and Texas.[2] As a result, only a portion of the LSC's total costs are attributed to CalAm. After taking into consideration the costs allocated to capital projects and rate cases, the table below summarizes the company's 2009 total projected operating costs for the LSC and CalCorp and the resulting allocations to CalAm:

[1] Response to OC-137.

[2] CalAm Rate Filing, Exhibit B, Chapter 3, Section 1.

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T
A R S C SC C C
T 00 A T SC C C C C A

Business Unit / Function	Total Costs	Allocation to Capital Expenditures and Rate Cases	Total Remaining Operating Expenses	CalAm's Allocation of Operating Expenses	CalAm Operating Expense Allocation %
LSC:					
Administration (A)	$2,788,698	($392,682)	$2,396,016	$746,600	31.16%
Business Development	2,020,833	--	2,020,833	353,278	17.48%
Asset Planning	495,073	(495,073)	--	--	N.A.
External Affairs	636,305	(95,510)	540,795	266,738	49.32%
Finance	1,638,646	(387,185)	1,251,461	451,189	36.05%
Human Resources	780,795	(72,921)	707,874	275,241	38.88%
Legal	1,292,922	(274,608)	1,018,314	569,947	55.97%
Maintenance	475,136	(71,316)	403,820	199,179	49.32%
Network	413,299	(7,954)	405,345	231,044	57.00%
Operational Risk	405,880	--	405,880	195,187	48.09%
Service Delivery	294,263	(44,167)	250,096	123,354	49.32%
Technical Services	363,187	(88,992)	274,195	135,231	49.32%
Environ Mgmt	145,167	(21,779)	123,388	--	0.00%
T SC	**11 0 04**	**1 18**	**8 01**	**3 46 88**	**36. 0**
C C N	**8 043 603**	**3 08 108**	**4 4 4**	**4 4 4**	**100.00**

Sources: CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Tables 1B and 1C, Company Workpaper GO-125, and to OC-141.

Note 1: LSC Business Unit / Function amounts were recomputed by Overland. Due to rounding, they may be slightly different than the company's internal computations.

Note 2: While CalAm was able to provide the underlying detail of its LSC projections by business unit / function, it could not do the same for CalCorp because non-labor dollars are budgeted only in total (per e-mail correspondence from Rebekah Pool on July 26, 2008).

(A) Overland attributed minor unreconciled differences between the CalAm Rate Filing and its own recomputations to the Administration Business Unit / Function.

Past Changes in the LSC and CalCorp Organizations

As described by CalAm in its rate filing, the LSC consists of employees located predominately in Phoenix, Arizona and several offices in California that provide administrative and professional support to subsidiaries in AW's Western Region.[3] From a functional standpoint, as evident in the preceding table, these employees provide regional shared services such as Administration, Finance, Human Resources, and Legal to both regulated and non-regulated businesses of American Water.

[3] CalAm Rate Filing, Exhibit B, Chapter 3, Section 1.

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CalCorp employees are all located in California and exclusively support CalAm.[4] CalCorp provides many of the same types of administrative and professional services to CalAm as the LSC currently does or had done previously (e.g., finance, legal, engineering, etc.). This is not completely surprising since a significant percentage of the dramatic growth in the CalCorp organization in the past several years can be attributed to employees reclassified from the LSC to CalCorp. This is demonstrated in Attachment 5-1 which is summarized in the following table:

Ta e 3
A e a ae e Reg o Se e Co a SC a Ca Co
ea o A
e e e 00 Ma 008

Description	LSC	CalCorp
e e e 9 00 ea o		**6**
Net Reclasses Between the LSC and CalCorp	(7)	7
New Positions Added	18	4
Old Positions Eliminated	(18)	--
e e e 30 006 ea o	**6**	**1**
Net Reclasses Between the LSC and CalCorp	(10)	10
New Positions Added	16	16
Old Positions Eliminated	(17)	(6)
e e e 31 00 ea o	**4**	**3**
Net Reclasses Between the LSC and CalCorp	--	--
New Positions Added	7	5
Old Positions Eliminated	(7)	(2)
Ma 31 008 ea o	**4**	**40**

Derived from responses to OC-7 and OC-92.
Note: The LSC employee headcount totals exclude 2 interns as of December 9, 2005; December 30, 2006; and May 31, 2008.

The 17 employees reclassified from the LSC to CalCorp (7 in 2006, and 10 in 2007) account for all but one of the 18-employee reduction (72 - 54) in the LSC in 2006 and 2007. CalAm attributes the exodus to a decision made by management to "shift to a strong state organizational structure."[5] In other words, some of the multi-jurisdictional duties of the LSC organization were grouped into distinct positions and assigned primarily to single-state-focused CalCorp.

CalAm should be indifferent to this change in assignment of employees between the LSC and CalCorp since its service level should be unaffected. (For example, if each employee of a 10-person Finance department at the LSC level is charging 20% of his / her time to CalAm before the "strong state organizational" shift, this would be equivalent to having 2 Finance employees at CalCorp working exclusively on CalAm with no additional assistance from the LSC Finance

[4] Responses to OC-7, OC-92, and OC-137.

[5] Quote attributed to response to OC-203. However, the idea of a state-focused organization was also mentioned in other data responses, including OC-88 and OC-137.

Department.[6]) However, this is not what actually occurred. Even though 17 fully-dedicated employees (post-reclassification) were "moved" from the LSC to CalCorp during 2006 and 2007, the LSC headcount equivalent that continued to charge CalAm did not change (27 in both 2005 and 2007), and the amount allocated to CalAm by the LSC remained nearly the same – $4,216,853 versus $4,207,831.[7]

With the exception of the one-person Service Delivery business unit / function, no new organizations were added to the LSC between December 2005 and May 2008.[8] The only business unit / function that increased substantially at the LSC during this time period was Legal, which would only account for four or fewer equivalent headcount attributable to CalAm.[9] In combination, neither of these groups provides a plausible explanation for the level of cost that continues to be charged to CalAm by the LSC.

When a company is subject to regulation in multiple jurisdictions, the movement of employees from one organization to another must be given particular attention. Especially when rate case test years in these jurisdictions involve different time periods, employees whose costs are shuffled from one jurisdiction to another are subject to manipulation and can be effectively recouped multiple times. To evaluate this risk, Overland requested information regarding other general rate cases in AW's Western Region, but CalAm did not provide a meaningful response.[10]

Overland recommends the allocation of the labor costs of the remaining employees who were reclassified from the LSC to CalCorp in 2006 and 2007 be limited to their pre-movement allocation percentages.[11] This will partially offset the increases in costs that were artificially created by the reclassification of employees from the LSC to CalCorp and mitigate the potential for manipulation of cost allocations in multiple jurisdictions.

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[6] In this simplified example, it is assumed that the salary levels of all employees are similar. Assigning only high-cost or only low-cost employees to CalCorp would skew the results.

[7] CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Tables 2 and 1B.

[8] Derived from responses to OC-7 and OC-92.

[9] Legal had seven employees in May 2008, the same number as projected in its 2009 request. For projection purposes, those seven employees were expected to charge the equivalent of 4 headcount to CalAm. In December 2005, Legal had one employee.

While the percentage increases in Maintenance and Operational Risk were arguably significant (200% and 50%, respectively), the actual number of employee additions was not (2 and 1, respectively).

[10] Response to OC-138.

[11] Overland considered all seventeen employees in its analysis. However, we concluded that five of the employees would have no impact on our recalculation either because these employees subsequently were reclassified to another organization (and thus were not included in the 2009 CalCorp request) or because the employees' post-movement job title implied that they had different responsibilities.

Chapter 5

LSC

CalAm's 2008 budget is the basis for test year 2009 LSC costs. However, unlike the NSC, the LSC's 2009 projection was inflated over 2008 levels. Most non-labor costs were inflated from 2008 to 2009 by 2.5%. Most 2008-2009 labor cost increases ranged from 3% to 5%.[12]

CalAm presented its test year LSC cost on an object-account basis (e.g., Salaries, Employees Expenses, Legal Services, etc.).[13] Because the underlying calculation of the allocations of the LSC non-labor costs were driven largely by business unit / function, the following table summarizes the data in this more relevant format. However, because CalAm grouped some of the business unit / function data differently when providing actual costs, the presentation is slightly different than that presented in Table 5-2.

T 4
A R S C SC
SC C U

Business Unit / Function	2006 Actual	2007 Actual	2008 Budget	2009 Request
Administration	$3,434,416	$3,684,466	$2,616,020	$2,788,698
External Affairs	721,306	632,551	614,390	636,305
Finance	3,228,805	1,722,629	1,577,768	1,638,646
Human Resources	698,273	585,844	752,897	780,795
Legal	763,329	704,046	1,247,575	1,292,922
Operational Risk	428,381	471,019	536,810	405,880
Environ Management	285,255	321,926	139,814	145,167
Engineering (A)	2,476,083	1,824,043	826,322	858,260
Operations (B)	4,053,064	3,477,841	3,091,854	3,203,531
Customer Service	552,594	581,028	--	--
Total Costs	$16,641,506	$14,005,393	$11,403,450	$11,750,204
Less: Capital Expenditures	(2,555,834)	(2,520,109)	(1,870,625)	(1,952,187)
Less: Non-Regulated	(4,038,461)	(2,250,914)	(1,878,574)	(1,960,594)
T R O E	10 04 11	34 3 0	6 4 1	83 4 3
C A ' A O E	4 86 14	4 0 831	3 4 1 4	3 46 88
T E A	6	60	C	C

Sources: Derived from responses to OC-110, OC-141, Workpaper GO-125, CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1B, and e-mail from Rebekah Pool dated July 21, 2008.

(A) Includes Technical Services and Asset Planning.
(B) Includes Network, Service Delivery, Maintenance, and Business Development.
(C) Amount obtained from company Workpaper GO-126 for 2008. Since there was no change in the FTE's charged to CalAm between 2008 and 2009, the 2008 total was carried forward to 2009.

Given the movement of employees between LSC business units and from the LSC to CalCorp and other organizations, we were not able to rely on fluctuation analysis at a business unit or

[12] Response to OC-141.

[13] See CalAm Rate Case Application, Exhibit B - Chapter 6 - Section 1 - Table 1B.

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function level as a basis for evaluating the test year. Instead, we performed a global, top-down review. Issues identified by the review are as follows.

LSC Headcount Included in CalAm's Request. Underlying CalAm's request to recover LSC-allocated costs is a projection that the LSC will employ 57 people who will charge a portion of their time (21 full-time equivalents according to the company) to CalAm in 2009.[14] As of May 31, 2008, the LSC employed 54 people (excluding two External Affairs interns).[15] The following table compares the headcount trend for the past several years with CalAm's forecasted test year:

T
A R S C SC
SC E

Description	12/9/05 Actual	12/30/06 Actual	12/31/07 Actual	5/31/08 Actual	2009 Test Year
Administration	5	7	3	3	4
Business Dev	11	7	5	6	8
Asset Planning	6	9	4	2	4
External Affairs	4	2	2	4	3
Finance	14	14	14	13	11
Human Resources	5	3	5	6	5
Legal	1	3	6	7	7
Maintenance	1	1	3	3	3
Network	8	8	5	4	5
Operational Risk	2	2	3	3	3
Service Delivery	--	--	1	1	1
Technical Svcs	1	3	2	--	2
Environ Mgmt	2	2	1	2	1
Production	5	3	--	--	--
Cust Relations	--	1	--	--	--
Engineering	7	--	--	--	--
T		6	4	4	

Sources: Responses to OC-7 and OC-92. Workpaper GO-126.

Note 1: LSC employee headcount totals exclude intern positions. Note 2: It is assumed that the 2009 total projected employees for the LSC are the same as 2008 since FTEs are the same for both years.

[14] CalAm Rate Case Filing, Exhibit B - Chapter 6 - Section 1 - Table 2 and Workpaper GO-126. Although Workpaper GO-125 indicates that 59 employees are included in the LSC, the underlying calculation of costs does not incorporate 2 of the positions. 2008 employee levels are assumed to be the same for 2009 since FTE's remained the same from 2008 to 2009.

[15] Response to OC-92.

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As the table demonstrates, employees assigned to the LSC organization have been decreasing for several years. CalAm's test year reflects a reversal of this trend. Overland believes that employees actually hired and employed mid-way through 2008 is a more objective starting point for calculating expected labor costs. Using positions actually filled in May 2008 rather than CalAm's projections, Overland recomputed the labor expense allocated from the LSC to CalAm. In addition, because the allocation of non-labor charges is a function of the resulting allocations of labor charges (either at a business unit / function level or an entity level), Overland also recalculated non-labor allocations for the entire LSC organization.[16] These changes are included in the adjustments discussed elsewhere in this report.

Jurisdictional Allocation of LSC Labor - Allocation of labor costs to Western Region jurisdictions is determined by the formula or billing code chosen by employees as they fill out time cards. In 2006 and 2007, over one-third of all hours charged by LSC employees was allocated on the basis of Western Region customer counts. (formulas 100014 and 100020). Of this, a little less than half was allocated to CalAm.[17] A significant portion of the remaining hours were directly charged to specific jurisdictions.

In projecting future jurisdictional allocations, CalAm relied on the judgment of the managers of each LSC function. As part of this process, employees identified as working entirely for one jurisdiction were directly assigned and those providing services to multiple jurisdictions were assigned to the LSC.[18] Projected jurisdictional allocations for the LSC were prepared at an employee level.[19]

To evaluate test year LSC employee allocations to CalAm, Overland asked for the historical allocations of time and labor costs for all LSC employees. CalAm did not provide a meaningful response to either of these requests.[20] As such, the only comparison of jurisdictional allocations we were able to make was at the entity level. As obtained from the rate filing, the following table summarizes CalAm's allocation of costs from the LSC (after taking into consideration allocations to capital expenditures):

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[16] Theoretically, changes in assumed headcount would also impact total dollars spent on such non-labor costs as employee training, employee expenses, telephone, etc. Since the relationship is not direct, Overland did not propose changes to the totals of these types of costs.

[17] Derived from responses to OC-29 and OC-85.

[18] Response to OC-181.

[19] Workpaper GO-126 and response to OC-141.

[20] Responses to OC-139 and OC-181. In OC-139, Overland asked for the 2006 and 2007 hours charged by LSC employee to each jurisdiction. CalAm limited its response to time charged by function to CalAm. In OC-181, Overland requested the underlying support for the allocation of 2007 LSC labor between jurisdictions by employee. CalAm provided a summary of time card formulas charged by employee. No explanation was provided for the resulting formula allocations nor for the raw data used in calculating the formulas.

Chapter 5

T 6
A R S C SC
A C C A

Description	2005 Actual	2006 Actual	2007 Actual	2008 Projection	2009 Projection
CalAm Allocation (A)	$4,216,853	$4,869,142	$4,207,831	$3,471,949	$3,546,988
Total LSC Costs:	12,970,330	16,641,506	14,005,393	11,403,450	11,750,204
Less: Capital Expenditures	(2,065,404)	(2,555,834)	(2,520,109)	(1,870,625)	(1,952,187)
T O ME	**10 04 6**	**14 08 6**	**11 48 84**	**3 8**	**8 01**
C A A C	**38.6**	**34.**	**36.64**	**36.4**	**36. 0**
Source: CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1B. Row (C) = Row (A) / Row (B)					

Given the organizational changes within functions, the results of this test are not definitive. However, it does suggest that the allocations from the LSC to CalAm are not unusually distorted in the test year.

Overland recommends the recomputation of jurisdictional allocations for employees whose costs were based on projected customer counts. As proposed by the company, this affects 23 employees.[21] Overland recommends that actual 2007 customer count data be used instead as it is a more objective measurement. This change in allocation factors would not have a material impact on the results of the analysis above.

<u>Capital Expenditure Assignments and Allocations</u>[22] - A portion of total LSC costs incurred are assigned to capital projects and not charged to operating expense. These capital projects are typically associated with property owned by the operating companies rather than one of the service companies.[23]

Costs assigned to capital projects occur in one of two ways. Either the employee directly charges a specific work order on his or her time card, or general capital charges are accumulated and distributed to multiple active projects using a pre-determined rate.[24] Projected capital expenditures for the rate case application were based on management estimates.[25]

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[21] Response to OC-141.

[22] CalAm combined capital project and rate case amounts in its disclosure. For purposes of discussion, we refer to the amounts deferred as capital expenditures.

[23] Response to OC-189.

[24] Response to OC-189.

[25] Response to OC-180.

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As was the case with a request for jurisdictional allocation back-up, Overland was not provided with the capital expenditure detail requested.[26] The following table summarizes the capital expenditures as a percentage of total LSC costs for the last three years and the two projected years employed in CalAm's rate application:

T
A R S C SC
C E .T C

Description	2005 Actual	2006 Actual	2007 Actual	2008 Projection	2009 Projection
Capital Expenditures	$2,065,404	$2,555,834	$2,520,109	$1,870,625	$1,952,187
Total LSC Costs:	12,970,330	16,641,506	14,005,393	11,403,450	11,750,204
Cap X as a % of Total	15.92%	15.36%	17.99%	16.40%	16.61%
Source: CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1B.					

Based on the limited data made available to us, the amounts assigned and/or allocated to projected capital expenditures do not appear to be significantly out of proportion to the total costs projected to be incurred at the LSC.

<u>Business Development Costs</u>. In its current rate application, CalAm is requesting recovery of expense from the LSC's Business Development business unit / function. Business development expenses are not included in current rates.[27] In fact, CalAm's testimony highlights business development a "potentially contentious" issue.[28]

According to the testimony of Christopher Buls, Vice President of Finance for the Western Region:[29]

> Business Development supports the regulatory business and benefits the customers by seeking regulated acquisition and other related growth opportunities which will increase the size of the customer base and its revenue stream , allowing fixed costs to be allocated to a greater number of customers.

In the past ten years, CalAm has completed six acquisitions (excluding the 2002 Citizens Utilities acquisition), which is equivalent to one every twenty months. Since 2005, CalAm's customer base has been as follows:

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[26] Response to OC-180. Overland requested the underlying support for the allocation of 2007 LSC labor between operating expense and capital expenditures. CalAm provided a summary of time card formulas charged by employee. No explanation was provided for the resulting formula allocations nor for the raw data used in calculating the formulas.

[27] Response to OC-14.

[28] CalAm Rate Filing, Exhibit B - Chapter 1 - Section 4 - Table 1.

[29] Direct Testimony, p. 19.

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Ta e 8 Ca fo aA e a ac C o e ae			
Year	2005	2006	2007 (A)
Water	169,358	169,475	167,866
Wastewater	2,369	2,281	2,248
To a	**1 1**	**1 1 6**	**1 0 114**

Sources: CalAm Rate Filing, Exhibit B - Chapter 9 - Section 1 - Table 6 and response to OC-90.

Note: Customer count data for CalAm was not consistently applied in the rate application and at times incorrect information was used (see response to OC-90).

(A) Excludes Felton district.

Excluding wastewater customers, CalAm forecasts that total water customers will increase to 171,298 in 2009.[30] Assuming that wastewater customer counts remain constant, this amounts to an increase of 3,432 customers over 2007 counts; or 1,716 customers per year. To add this 1% per year to its customer base, CalAm proposes that it be allowed to annually recover $352,746 in Business Development allocated from the LSC, and an additional $30,439 from the NSC.[31]

On a per customer basis, the 2009 LSC costs allocated to CalAm without Business Development allocations or the projected increases in customer base are:

$18.78 per year per customer = ($3,546,988 - $352,746) / 170,114 customers

Including the Business Development function in cost of service and assuming the projected increase in customer base, the per customer amount after the second year is:

$20.44 per year per customer = $3,546,988 / (170,114 + 3,432)

Thus, CalAm's request is to add 8.8% to LSC cost per customer for Business Development.

The premise of adding business development costs to regulated expense is that customers acquired through the effort will benefit rates by spreading costs over a larger customer base. In this case there is no evidence that LSC business development efforts have noticeably added to the CalAm customer base in the past, and the minor customer count increases projected in the rate case obviously do not justify the additional costs included in CalAm's request. As a result, Overland recommends that the expense of the LSC Business Development function be excluded from CalAm's requested revenue requirement.

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[30] CalAm Rate Filing, Exhibit B - Chapter 9 - Section 1 - Table 6 and response to OC-90. Adjusted to exclude Felton district (1,330).

[31] $352,746 is the amount referenced by the company in its application. This is slightly different than the amount disclosed in its workpapers and responses to data requests.

Chapter 5

Other LSC Issues

Payroll Reserve - Before jurisdictional and capital expenditure allocations, CalAm included $102,500 for an LSC "bonus or promotional increase reserve" in its request. According to CalAm, this was intended to offset any awarded raises outside of normal merit increases, non-budgeted promotions, and vacant positions filled at higher pay due to changes in market conditions.[32] However, just as positions may be filled with people who are paid at higher rates than originally projected, some will be filled with people who are paid less than originally budgeted. CalAm has already included an average inflation component in its LSC base salary projections of 3.6% between 2008 and 2009.[33] Overland does not believe it is necessary to layer another 2.0% of unspecified labor increases on top of these projected costs. We recommend the payroll reserve be excluded from CalAm's test year expense.

Base Salary Omissions - Based on a review of the support for LSC's labor costs allocated to CalAm, Overland discovered that the base salaries of two employees in the Operational Risk business unit / function had been omitted from the 2009 projections.[34] CalAm confirmed that this had been done in error.[35] In its adjustments, Overland recommends that these omitted costs be included in CalAm's request.

Incentive Compensation - Included in the costs allocated to CalAm from the LSC are costs associated with incentive compensation ($233,430 and $241,823 in 2008 and 2009, respectively). These allocations are based on estimates for LSC employees of $764,729 in 2008 and $792,224 in 2009.[36] LSC employees received only $479,116 in incentive pay associated with the 2007 plan year.[37] Overland requested support for the higher incentive pay projections and received plan documentation for employees assigned to salary bands 14 through 5.[38] No documentation was provided for higher-level employees in salary bands 4 through 1. We recommend excluding the unsupported incentive compensation associated with employees in salary bands 4 through 1 and we recommend the 2007 plan year awards be used as a basis for the test year. Incentive compensation and our recommended adjustment is discussed in more detail in Chapter 2.

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32 Response to OC-179.

33 Derived from the response to OC-141. This computation adjusts for the fact that CalAm erroneously did not include the base salaries of two employees within its Operational Risk function in 2009.

34 Response to OC-141.

35 E-mail from Rebekah Pool dated August 2, 2008.

36 Response to OC-141.

37 Response to OC-20.

38 Response to OC-182.

CalCorp

CalCorp is a service company organization with employees stationed in offices throughout California.[39] Its costs are entirely charged to CalAm.[40] CalCorp provides administrative services in functional areas similar to those in the LSC. They include:[41]

- Business Unit No. 51001 - Network
- Business Unit No. 51005 - Administrative
- Business Unit No. 51006 - Field Services (Service Delivery)
- Business Unit No. 51012 - Finance / Rates
- Business Unit No. 51014 - Engineering
- Business Unit No. 51016 - Maintenance
- Business Unit No. 51026 - Project Delivery
- Business Unit No. 51027 - Planning (Developer Services)

While CalCorp prepared its labor cost projections by employee, its non-labor cost projections were only available at the entity level by object account.[42] Attachment 5-2 presents CalCorp's 2006 and 2007 actual costs side-by-side with 2008 and 2009 projections. Differences between this exhibit and CalAm's Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1C are due to an oversight by the company when submitting its application.[43] Because the error was related to historical amounts only, it had no impact on the company's request.

As previously noted, CalCorp has undergone a transition in the past few years as employees who once were housed in the LSC have been reassigned to CalCorp. As Table 5-3 shows, at the end of 2005, CalCorp had six employees. Two and one-half years later, it had 40 employees.

<u>CalCorp Headcount Included in CalAm's Request</u>. CalAm has included 51 CalCorp employees in its 2009 test year GO revenue requirement.[44] As shown in the following table, this is substantially in excess of actual headcount as of May 31, 2008:

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[39] Response to OC-92.

[40] Response to OC-137.

[41] Response to OC-165.

[42] Response to OC-142 and e-mail clarification from Rebekah Pool dated July 28, 2008.

[43] Response to OC-124.

[44] CalAm rate filing, Exhibit B - Chapter 6 - Section 1 - Table 2.

Chapter 5

Ta e A e a ae Ca fo a Co o a e Se e Co a Ca Co E o ee e e					
Description	12/9/05 Actual	12/30/06 Actual	12/31/07 Actual	5/31/08 Actual	2009 Projection
Network	--	--	2	3	--
Administrative	1	10	11	9	11
Field Services	--	--	3	3	3
Finance / Rates	--	1	7	8	11
Engineering	--	--	2	7	3
Maintenance	--	--	--	2	3
Project Delivery	4	4	8	8	10
Planning	1	2	4	--	9
Legal	--	--	--	--	1
To a	**6**	**1**	**3**	**40**	**1**

Source: Responses to OC-92, OC-7, and OC-166.

Note: The 2009 projections are listed by "department." The historical data is listed by "business unit." Although both classifications use common terminology, there may be differences that would complicate any comparisons made between the two.

A significant percentage of the historical employee increase shown above is due to the reclassification of LSC employees to CalCorp. The increase in CalCorp A&G personnel in 2006 and 2007 came at a time when CalAm had a static customer base. This, together with the fact that allocations from the LSC have not decreased, indicates that the combined LSC and CalCorp organizations are becoming less efficient.

On top of increases that have already occurred, CalAm's GO revenue requirement proposes to increase the CalCorp workforce by another 27.5% between May 2008 and 2009. Overland does not believe that this increase is warranted and recommends that test year labor from CalCorp be limited to positions filled as of May 31, 2008.

<u>Reclassification of LSC Employees to CalCorp</u>. In 2006 and 2007, seventeen employees were "moved" from the multi-jurisdictional service provider LSC to the CalAm-focused CalCorp organization. Only one of these employees actually physically moved to another city, and with a lone exception, all had the same or a very similar position titles after the organizational transfer.[45] It is quite possible that sixteen of the seventeen employees worked from the very same office before and after this organizational change.

All other things being equal, the re-branding of these employees from LSC to CalCorp resulted in a shift of costs from other jurisdictions to CalAm. When working at the LSC, labor costs of many of these employees were directly assigned or allocated to five different jurisdictions. At Cal-Corp, they are assumed to work entirely for CalAm.

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[45] Responses to OC-7 and OC-92 after taking into consideration global job type and description changes.

As discussed above, the decision to focus on a "strong state organizational structure" should have resulted in the same or lower cost allocation to CalAm from the combined LSC and CalCorp organizations, assuming the change "reduce[d] conflicting priorities."[46] Instead, total operating costs have increased from approximately $6,584,000 in 2005 ($4,218,000 from the LSC and $2,366,000 from CalCorp) to approximately $7,779,000 in 2007 ($4,208,000 from the LSC and $3,571,000 from CalCorp). For 2009, CalAm's requested allocations exceed $8,501,000, a 29% increase over 2005.[47]

Overland has addressed part of this increase by recommending that CalCorp only be allowed to charge CalAm for employees on the payroll as of May 31, 2008. In addition, Overland believes that the potential for cost allocation manipulation can be partially mitigated by limiting CalAm's test year to labor allocations based on the organization before management decided to adopt a "strong state organizational structure." Regarding the latter, the focus of our review was on the 17 employees who were re-assigned from the LSC to CalCorp in 2006 and 2007.

Of the 17 LSC employees re-branded as CalCorp, three were not included in CalCorp's 2009 labor projections, and two had notable changes in position descriptions. It is not necessary to make an adjustment for these employees. For the remaining 12 employees, we recommend a test year allocation to CalAm based on percentages effective in the time period immediately before they were "moved" from the LSC to CalCorp.

<u>Costs Associated with Legislative and Political Influence</u> - In Decision 03-02-030, the Commission disallowed the inclusion of CalAm's Director of Government Affairs position in rates. The Commission was particularly concerned with the lobbying aspects of the position. The disallowed position had the following responsibilities:[48]

- Monitors and provides input to positively influence proposed legislation and emerging issues that could affect the company.
- Assists in determining action or positions regarding governmental matters.
- Develops and maintains effective working relationships with federal, state and local legislators, officials and members of regulatory authorities.
- Assists the President in communicating with government officials at all levels regarding company positions on federal/state legislation and regulations.
- Coordinates communications and personal contacts by company management with elected and appointed officials.

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[46] Response to OC-88 (B Kent Turner discussion).

[47] CalAm Rate Filing. Exhibit B - Chapter 6 - Section 1 - Tables 1A.

[48] CPUC D.03-02-030, pp. 22-23.

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In the current rate filing, CalAm has requested that costs incurred by CalCorp for a Director Government Affairs (State) be included in its rates.[49] As with the position reviewed previously by the Commission, this position reports directly to the President according to the company's organization chart.[50]

CalAm provided a job description for the Director Governmental Affairs (Job Code 450702) that lists the exact same five responsibilities as the position previously rejected by the Commission.[51]

In its adjustments, Overland recommends that the labor costs associated with this position be excluded from CalAm's rates.

Other CalCorp Issues

Incentive Compensation - O&M expense assigned from CalCorp includes forecasted incentive compensation of $264,925 and $274,451 in 2008 and the 2009 test year, respectively. These amounts are based on CalCorp incentive award estimates of $523,091 in 2008 and $541,898 in 2009.[52] Total CalCorp incentive awards for the 2007 plan year were $293,454.[53] When we requested support for the higher test year forecasts, we received incentive plan documentation for employees assigned to salary bands 14 through 5, but not for higher level manager in salary bands 4 through 1.[54] After excluding the unsupported incentive compensation for employees in salary bands 4 through 1, Overland recommends that test year incentive compensation be limited to 2007 plan year awards, adjusted for salary inflation through the test year. Incentive compensation is discussed in detail in Chapter 2.

CalCorp Labor Separately Requested as Rate Case Expense - As noted in Chapter 7, the time and associated labor costs of certain CalCorp Rate Department employees are being requested in both the operating expenses allocated by CalCorp to CalAm and deferred rate case expenses (amortized over a three-year period). This request is not particularly unusual except that CalAm has requested that more than 100% of four salaried employees' labor costs be permitted in rates.[55]

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[49] Response to OC-92.

[50] Response to OC-2.

[51] CalAm only provided one job description for the Director Governmental Affairs. As listed on the job description, this position reports to the Company President (Regional Level). While the Job Code for this job description is different than the Job Type listed in the employee listing provided in response to OC-92, it is nearly certain that the two positions are one and the same.

[52] Response to OC-142.

[53] Response to OC-20.

[54] Response to OC-182.

[55]

Chapter 5

As an example, CalAm projects that an analyst will spend 799 hours of her time on the current rate application.[56] Assuming no holidays or personal time off, this equates to 38.4% of her available annual hours (799 / 2,080). At the same time, management also concluded that the analyst will spend 90% of her time on CalAm matters charged entirely to operating expense.[57] In effect, CalAm has included nearly 2,700 hours of the analyst's time (and more importantly, her labor costs) in this rate filing (799 rate case hours + 1,872 operating expense hours, the latter being 90% of 2,080 hours in a year). The company treated the labor expense of three other CalCorp employees similarly. CalAm's rationalizes this by claiming that time associated with rate cases is dictated by the way the current revenue requirement was developed in the past, but time associated with operating expenses will be guided by its new organizational structure and a new philosophy on labor distributions.[58]

Overland is not persuaded by the company's explanation. In its application, the company is requesting that ratepayers fund at least 115% of the labor costs of four different CalCorp employees, and that is a conservative estimate. As noted previously, Overland has not included any estimates of employee time off for holidays, vacation, training, or sickness. In addition, if labor costs of these employees are being recovered in rate case expenses of other jurisdictions, Overland's estimate of over-recovery is further understated.

In our adjustments, we have excluded the labor costs in excess of 100% of available hours for these four employees.[59]

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[56] Response to OC-54, Company Labor support.

[57] Derived from OC-142 ($84,274 of total allocations to operating expense / $93,638 of total labor costs).

[58] Response to OC-182.

[59] Two of the four employees were involved in the CalCorp reclassification of LSC employees. Because their allocation of labor costs was previously adjusted to levels that are consistent with the rate case costs being requested, it was not necessary to make a second adjustment.

LSC and Cal Corp
Employee Count Activity
December 2005 - May 2008

Home Business Unit	Dept Name	12/9/2005 Employee Count	Net Transfers (to) / from Other Depts	Net Movements between LSC & Cal Corp	New Positions Added to Dept	Old Positions Eliminated from Dept	12/30/2006 Employee Count	Net Transfers (to) / from Other Depts	Net Movements between LSC & Cal Corp	New Positions Added to Dept	Old Positions Eliminated from Dept	12/31/2007 Employee Count
33001	WE-Production	5	(2)		2	(2)	3	-		-	(3)	-
33002	WE-Network	8	(2)		4	(2)	8	-	(1)	-	(2)	5
33003	WE-Customer Relations	-	1		-	-	1	-		-	(1)	-
33004	WE-Tech Services	1	-		2	-	3	(1)		-	-	2
33005	WE-Administration	5	4		-	(2)	7	-	(2)	1	(3)	3
33006	WE-Service Delivery	-	-		-	-	-	1		-	-	1
33007	WE-Finance	14	-		2	(2)	14	-	(5)	5	-	14
33011	WE-Environmental Management	2	-		-	-	2	-		-	(1)	1
33014	WE-Engineering	7	-	(5)	-	(2)	-	-		-	-	-
33015	WE-Legal	1	-		3	(1)	3	-		4	(1)	6
33016	WE-Maintenance	1	-		-	-	1	-		2	-	3
33018	WE-Human Resources	5	-	(2)	1	(1)	3	-		2	-	5
33019	WE-Operational Risk	2	-		-	-	2	-		1	-	3
33020	WE-Business Development	11	(2)		1	(3)	7	-	(1)	-	(1)	5
33025	WE-External Affairs	4	-		-	(2)	2	-		-	-	2
33028	WE-Asset Planning	6	1		3	(1)	9	-	(1)	1	(5)	4
		72	-	(7)	18	(18)	65	-	(10)	16	(17)	54
51001	CAL-Corp	-					-	-	1	1	-	2
51005	CAL-Corp	1	-	6	3	-	10	(6)	3	7	(3)	11
51006	CAL-Corp	-					-	-	1	2	-	3
51012	CAL-Corp	-	-	-	1	-	1	-	4	2	-	7
51014	CAL-Corp	-					-	-	1	1	-	2
51016	CAL-Corp	-					-					-
51026	CAL-Corp	4	-	-	-	-	4	4	-	1	(1)	8
51027	CAL-Corp	1	-	1	-	-	2	2	-	2	(2)	4
		6	-	7	4	-	17	-	10	16	(6)	37

Sources: Responses to OC-7 and OC-92.

LSC and Cal Corp
Employee Count Activity
December 2005 - May 2008

Home Business Unit	Dept Name	(cont. from previous pg) 12/31/2007 Employee Count	Net Transfers (to) / from Other Depts	Net Movements between LSC & Cal Corp	New Positions Added to Dept	Old Positions Eliminated from Dept	5/31/2008 Employee Count
33001	WE-Production	-	-		-	-	-
33002	WE-Network	5	-		-	(1)	4
33003	WE-Customer Relations	-	-		-	-	-
33004	WE-Tech Services	2	-		-	(2)	-
33005	WE-Administration	3	-		-	-	3
33006	WE-Service Delivery	1	-		-	-	1
33007	WE-Finance	14	(1)		1	(1)	13
33011	WE-Environmental Management	1	-		1	-	2
33014	WE-Engineering	-	-		-	-	-
33015	WE-Legal	6	-		1	-	7
33016	WE-Maintenance	3	-		-	-	3
33018	WE-Human Resources	5	-		1	-	6
33019	WE-Operational Risk	3	-		-	-	3
33020	WE-Business Development	5	1		1	(1)	6
33025	WE-External Affairs	2	-		2	-	4
33028	WE-Asset Planning	4	-		-	(2)	2
		54	-	-	7	(7)	54
51001	CAL-Corp	2	-	-	1	-	3
51005	CAL-Corp	11	(3)	-	1	-	9
51006	CAL-Corp	3	-	-	-	-	3
51012	CAL-Corp	7	1	-	-	-	8
51014	CAL-Corp	2	2	-	3	-	7
51016	CAL-Corp	-	2	-	-	-	2
51026	CAL-Corp	8	-	-	-	-	8
51027	CAL-Corp	4	(2)	-	-	(2)	-
		37	-	-	5	(2)	40

Sources: Responses to OC-7 and OC-92.

Attachment 5-2

Cal Corp
2006 - 2009
Detail by Account #

Account	Actual 2006	Actual 2007	Budget 2008	Budget 2009	
Salaries	1,045,068	2,484,846	5,007,409	5,210,411	
Payroll Taxes - FICA	64,939	75,974	323,064	331,744	
Payroll Taxes - FUTA & SUTA	8,014	8,108	19,478	19,870	
Group Insurance	-	-	635,846	699,924	(B)
Oper Admin & Gen	84,553	-	-	-	
Employee Awards	1,226	100	-	-	
Employee Physical Exam	399	710	-	-	
Tuition Aid	1,264	183	-	-	
Training AG	(32,902)	25,194	-	-	
Temp Employee Oper Admin & Gen-AG	10,224	1,254	-	-	
Bill Inserts Admin & Gen	10,163	3,059	-	-	
Brochures and Handouts	1,691	225	-	-	
Office & Admin Supplies	40,793	38,809	42,361	43,420	
Contr Svc - Accounting	88,573	153,232	86,924	89,097	
Contr Svc - Legal	111,780	184,958	20,000	20,500	
Contr Svc Other-WT	-	-	-	-	
Contr Svc Other-AG	80,947	184,405	82,472	84,534	
Temp Employee Oper Admin & Gen-SS	-	-	-	-	
Rents - Real Property AG	3,428	2,952	336,220	348,410	(A)
Transportation	(99,929)	(101,933)	(359,831)	(375,664)	
Trans Oper Admin & Gen Lease Cost	180	80	-	-	
Trans Oper Admin & Gen Lease Fuel	1,246	378	-	-	
Trans Oper Admin & Gen Lease Main	16,693	1,179	-	-	
Ins Vehicle Oper AG	87,270	97,634	107,004	118,000	
Miscellaneous Operating Exp	23,143	42,068	-	-	
Misc Oper AG	90,289	(1,786)	-	-	
Misc General Office	-	-	-	-	
Advertising	18,099	24,745	-	-	
Bank Service Charges	171,745	218,860	179,509	183,997	
Bank Service Charges	6,407	(6,199)	-	-	
Bill Inserts	-	-	-	-	
Collections Agencies	22,132	22,397	26,826	27,503	
Condemnation Costs	(50,000)	-	-	-	
Conservation Exp	15,107	(6,600)	-	-	
Credit Line Fee	68,942	91,061	88,791	86,625	
Directors Fees	12,000	13,531	12,000	12,000	
Directors Exp	1,804	295	2,000	2,000	
Dues / Membership Deduct	1,536	3,857	12,108	7,508	
Employee Travel Exp Admin & Gen	15,168	173,307	197,218	202,148	
Empl Exp Conf / Registration	1,653	12,875	15,000	21,400	
Meals	1,982	12,676	-	-	
Meals & Travel Non Deduct	1,688	12,206	-	-	
Forms	150,656	178,402	161,130	165,164	
Forms AG	569	786	-	-	
Lobbying Expenses	-	-	-	-	
Merger Transaction Costs	10,735	-	-	-	
Office & Admin Supplies	7,499	4,507	1,200	1,200	

Attachment 5-2

Cal Corp
2006 - 2009
Detail by Account #

Account	Actual 2006	Actual 2007	Budget 2008	Budget 2009
Overnight Shipping Admin & General	12,864	3,550	1,200	1,200
Penalties Non Deduct	1,283	-	-	-
Research Develop Exp	25,565	26,205	26,863	27,535
Security Services AG	-	-	-	-
Software Licenses & Supp	44,210	97,419	47,441	48,627
Telephone Admin & Gen	4,749	18,307	2,400	2,400
Cell Phone Admin & Gen	59,313	32,367	18,696	19,163
Wireless Service	68,140	62,335	49,643	50,885
Trash Removal Admin & Gen	87	-	-	-
Mat & Sup Admin & General	(1,018)	322	-	-
Contract Services Other	-	-	-	-
Miscellaneous Maint Exp	110,121	88,294	105,739	106,526
Amort Def Maint TD	-	-	-	-
Depreciation	937,279	405,792	487,476	487,476
	3,359,368	4,692,926	7,736,187	8,043,603
CAP EX	(799,678)	(1,121,407)	(2,968,129)	(3,089,108)
O&M (TOTAL LESS CAP EX)	2,559,690	3,571,519	4,768,058	4,954,495

(A) Due to the "restructuring" of personnel, CalAm chose to treat Chula Vista office lease costs and rental and maintenance on equipement as Cal Corp costs rather than as a cost of the LSC (Rate case filing, Discussion of Exhibit B - Chapter 6 - Section 1).

(B) CalAm inadvertently excluded Group insurance for 2006 and 2007 from its application (Exhbit B - Chapter 6 - Section 1 - Table 1A). Its disclosure of Group Insurance in Table 1C was also not comparable to its projections as historical amounts included costs for all CalAm employees, not just those of CalCorp (see response to OC-124). 2008 and 2009 budgets only include costs for Cal Corp employees. For purposes of this schedule, details supporting historical costs associated with Table 1A were presented.

6. RWE Acquisition and Spin-off of Interest in American Water; Analysis of Synergy Savings from Citizens Acquisition

In this Chapter, Overland provides an analysis of CalAm or American Water compliance, where possible, with "Conditions" imposed by the Commission; initially with regard to the acquisition of American Water by RWE, and more recently of the divestiture of the RWE interest in the company.

This Chapter also addresses ongoing requirements imposed by the Commission associated with: the CalAm acquisition of water assets previously owned by Citizens Utilities; specifically the analysis of synergy benefits imputed due to the operation of these properties by CalAm in relation to the acquisition premium allowed in rates to date.

Finally, potential implications of the recent sale of the Felton assets on the amount of acquisition premium recoverable from CalAm customers is addressed.

Transfer of Control of Stock Ownership from RWE to American Water

Control of American Water Works Company, Inc. ("American Water") was transferred to RWE Aktiengesellschaft ("RWE")[1] in 2003.[2] At that time, RWE provided water and wastewater services to about 43 million people worldwide. The American Water acquisition was intended to expand RWE operations to the U.S.[3]

The transfer of control to RWE was expected to produce economic benefits to ratepayers, including: sharing of best practices; lowering CalAm's cost of debt; deferring a rate increase; implementing two public assistance programs; and adopting affiliate transaction rules.[4]

In Decision 06-11-050 dated November 30, 2006, the Commission addressed RWE savings recognized in setting rates for the Monterey and Felton districts. The CalAm estimate of savings due to the RWE acquisition was $1,023,204 for 2006. This estimate was accepted as part of the settlement of the GRC proceeding. The underlying record in GRC proceeding provided the actual basis for the RWE savings estimate. The primary factors were: the impact of improved procurement practices and expected savings from changes in IT systems.

[1] Thames Water Aqua Holdings GmbH is the intermediate holding company for most of the water and wastewater operations of RWE, which holds the investment in American Water.
[2] The Commission actually approved the transfer in D.02-12-068 on December 19, 2002.
[3] CPUC Decision 07-05-031, dated May 3, 2007, page 7.
[4] CPUC Decision 02-12-068, dated December 19, 2002, page 13.

The impact of any improvements in procurement practices is now embedded in the historical data relied upon to forecast costs. This is also true for costs associated with the changes made in IT systems utilized.[5] For these reasons, as well as the fact that RWE is in the process of divesting its interest in American Water, there is no basis at this time to assume that any RWE related benefits can be expected beyond the levels embedded in historic costs.

In D.07-05-031, the Commission approved the transfer of indirect control of CalAm from RWE to American Water through the sale of up to 100% of the shares of common stock through an IPO and subsequent offerings. At the time of the CPUC Order in May 2007, CalAm represented less than 5% of the American Water regulated operations.[6]

The position of Applicants in requesting approval for the spin-off from RWE is summarized by the Commission at page 10 of D.07-05-031 as follows:

> Applicants contend that their proposed transaction meets the requirements of § 854 (a) because it will result in a company with sound financial structure focusing on the water and wastewater business in the United States that will be ***well managed and will provide benefits to ratepayers. Although applicants cannot quantify the benefits from the proposed transaction, they identify them as significant.*** Those ratepayer benefits include a solid capital structure; ability to raise capital on a going forward basis; becoming a United States publicly traded company; ***local control***; enhancement of employee relations; and ***transparency to CalAm's ratepayers.*** (emphasis added)

In its Decision to approve the transfer of ownership, the Commission imposed the following conditions, among others:

1. The authority granted by Ordering Paragraph 1 is subject to complying with the 11 conditions set forth in Appendix A to this Order.
2. None of the acquisition conditions from Decision 02-12-068 should be removed until RWE (or its subsidiaries or affiliates) has sold more than 90% of its interest in American Water... (page 39)

The acquisition conditions in Decision 02-12-068 were attached as Appendix C. Both Appendix A and Appendix C are attached herein as Attachments 1 and 2, respectively.

CalAm represents that it has addressed its compliance with the conditions imposed by Decision 02-12-068 by its submission of Exhibit E, Chapter 1, Section 1.[7] Similarly, CalAm represents that it complied with applicable conditions imposed in Decision 07-05-031 by virtue of its submission of Exhibit E, Chapter 1, Section 10.[8]

[5] Actual results in changes to IT systems failed to produce the expected cost reductions estimated in the last GRC case (per Dave Stephenson August 27, 2008).
[6] CPUC Decision 07-05-031, dated May 3, 2007, page 6.
[7] Response to OC-96, page 2.
[8] Ibid, pages 1-2.

A review of Exhibit E, Chapter 1, Sections 1 and 10 reveal that CalAm's idea of compliance is generally met by one sentence statements that may be characterized as: a) an unsupported representation that the condition has been met or that CalAm is in compliance; b) that compliance with certain conditions will be demonstrated in future GRC applications; c) a general qualitative statement, absent any empirical support; or d) a reference to some other document or documents not contained in the filing itself or in the accompanying workpapers[9].

Referring specifically to Exhibit E, Section 10, page 3 of 3, CalAm identifies that "Condition 11" of Decision 07-05-031 provides for the continued requirement to provide a showing of compliance with the conditions originally set forth by the Commission in approving the acquisition of American Water in the first instance.[10] There were numerous conditions imposed by the Commission; many of which remain applicable today. Relevant conditions that continue at this time include:

- Condition 2 – Adequate capital required to fulfill service obligations.
- Condition 6 – No adverse impact on customer service.
- Condition 15 – CalAm's equity to capital ratio must be at least 35%.
- Condition 16 – Notification of downgrading of bonds by rating agencies.
- Condition 19 – Cost of new debt will not increase due to RWE ownership.
- Condition 22 – Track costs and benefits associated with implementation of "best practices".
- Condition 23 – Commit funds to support low-income assistance programs.
- Condition 24 – Commit funds to support a "Small System Technical Advisory Team".
- Condition 26 – Notification of dividends to parent in excess of 75%.
- Condition 29 – Expected savings associated with implementation of "advanced project delivery" methods.

The following represents the CalAm evidence of compliance filed in its application, as well as in its response to Overland discovery.[11]

> **Co a e A o** – California American Water will demonstrate compliance with this condition in future GRC applications.

Overland assumes that the Commission imposed conditions in previous proceedings for good cause, and with the intent to exercise its regulatory oversight responsibilities in protecting regulated water utility customers against potential harm arising from unintended circumstances subsequent to its approval of transactions associated with the

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[9] Supplemental Response to OC-34. This amended response provides various references to what is apparently an August 20, 2007 draft version of American Water's S-1 filing actually made on August 27, 2007. The excerpts referenced were not produced in the response, nor is the document otherwise produced in discovery. The references are inconsistent with the August 27, 2007 S-1 filed with the Securities and Exchange Commission. In any event, the S-1 generally addresses American Water consolidated operations and its major business unit or subsidiary operations. There is no discussion of RWE and American Water compliance with CPUC conditions imposed in D.07-05-031.

[10] CPUC Decision 02-12-068, dated December 19, 2002, Appendix C.

[11] Response to OC-34; see also Application Exhibit E, Chapter 1, Section 10.

RWE acquisition, and subsequent spin-off its investment in American Water. We believe that the submission of evidence by CalAm with regard to the conditions required by these previous proceedings is insufficient for the Commission to exercise its intended review and authority over the potential or intended effects of its RWE authorizations previously referenced.

The potential concerns of the Commission in monitoring CalAm and American Water operations, as reflected by the conditions imposed in the proceedings referenced above, are further justified by a number of specific factors now known, which include:

- Credit ratings lowered for American Water Capital Corp. by Moody's on October 12, 2007, and by S&P on June 19, 2008.
- Write-down of goodwill through December 31, 2007 of $1.1 billion; with an additional asset impairment through June 30, 2008 of $750 million.[12]
- Internal cash flows from operations will not be sufficient to fund forecasted capital expenditures, thus requiring significant capital from new debt and equity offerings.[13]
- The current equity ratio is approximately 47%. However, there is a risk of erosion due recognition of further asset impairments in the goodwill of $1.7 billion that remains on American Water's balance sheet at June 30, 2008.[14]

Overland requested data to support and verify compliance with the conditions required by the RWE decisions previously identified. Aside from its references to Exhibit E, it also provided references to an August 20, 2007 draft version of an S-1 filing for Conditions 1-6, while stating that "Compliance will be demonstrated in future general rate case applications" for Conditions 8-12.[15] In a follow-up request, Overland made the following statement.[16]

> ...Overland again requests the production of actual documentation of compliance with applicable conditions. Overland does not believe that it is its responsibility to define "the specific information required for a specific condition" [17], as it believes that CalAm should make a good faith effort to address and document compliance consistent with the intent of the CPUC Orders approving this matter...

CalAm did not produce any documents, empirical evidence, quantitative analysis or documentary support in response to OC-96. However, to the extent that Overland was

[12] American Water S-1/A dated April 1, 2008, page 45; and June 30, 2008 10-Q, page 5. Recognition of these impairments commenced in 2005, and generally relate to the goodwill recognized due to the RWE acquisition of American Water in 2003.

[13] Forecasted capital expenditures are at approximately $1.1 billion per year in 2008 to 2012. New debt and equity funding is expected to be approximately $3.0 billion over that period. Response to OC-99, Goldman Sachs research report dated June 2, 2008, page 19. S&P (at page 3 of its June 19 Research Update) puts the expected capital expenditures at $4 to $4.5 billion over the next five years; somewhat lower than the Goldman Sachs forecast. Response to Discovery OC-98.

[14] American Water June 30, 2008 10-Q, pages 3 and 4.

[15] Response to OC-34; Supplemental Response relating to D.07-05-031 conditions.

[16] Discovery Request OC-96.

[17] Response to OC-34.

able to gain information relevant the conditions established in the RWE decisions, the following discussion and analysis is provided.[18]

a e a . CalAm has no management level reporting of water quality statistics that provide summary analysis or comparative data. It apparently relies solely on its Consumer Confidence Reports ("CCRs") for information about water quality.[19] These reports are developed annually, by district, and distributed to customers.

Attachment 3 includes data derived from CalAm's Consumer Confidence Reports for the Monterey district published for the years 2003-2007. We have compiled the data in this attachment for comparative purposes. The attachment shows the Maximum Contaminant Level (MCL) allowed for certain substances as determined by the State of California and the U.S. EPA and the average amount detected as reported in that year.[20] No violations were reported for any of the reported substances.

o o e A a e P og a . Commencing in February 2007, and through the period to April 2008, CalAm had spent approximately $99,000 of a $250,000 commitment for low income assistance programs (CPUC Condition 23) it has recorded as a liability in its financial statements. The following is a detail of these expenditures by district:[21]

Ta e 6 1
Ca fo a A e a a e

District	Amount
Sacramento	$69,338
Larkfield	4,211
Felton	7,307
Los Angeles	18,321
To a	**99 1**

"S a S e Te a A o Tea " P og a . The actual and planned expenditures for this program are as follows.[22]

[18] Overland did not have the time or resources to continue through multiple rounds of discovery to attempt to induce CalAm to provide relevant information to support its filing requirements in the face of its position that the information contained in its application had already met its burden of proof.

[19] Response to OC-97.

[20] As stated in the reports, while most monitoring was conducted during the year reported, certain substances are monitored less than once per year as levels do not change frequently. Based upon the reports, these substances include Gross Alpha Particle Activity, Combined Radium, Copper and Lead. The CCRs for 2003-2005 included sample results for those substances from 2003. Sample results from 2005 for Arsenic, Fluoride, and Selenium were included in both the 2005 and 2006 CCRs. 2005 sample results were included in the 2007 report for Gross Alpha Particle Activity, Combined Radium, Uranium, Copper and Lead, while testing had been performed and reported in 2006.

[21] Response to OC-45.

[22] Response to OC-46.

T 6 C A		
Description	Year	Amount
Ponderosa Sky Ranch Water System	2004	$ 10,000.
Ponderosa Sky Ranch Water System	2005	20,000.
Live Oaks Springs Water Company	2006	12,010.
Matt Dillon Water Company	2006	55,750.
San Jerado Water System	2006	37,000.
Ramona Water Company	2007	27,636.
Actual Expenditures through 2007		$162,396.
Ramona Water Company (planned)	2008	49,900.
T P E		**1 6.**

CPUC Condition 24 required a commitment of $50,000 per year for five years from the closing of the RWE transaction.

A C R . Goldman Sachs initiated coverage of AWW in a June 2, 2008 research report. The report addressed accounting controls and financial reporting as follows.

> **M**
> American Water has reported material weaknesses in internal accounting controls. While we believe the company has adequately increased controls and accounting staff, these weaknesses may have not been fully addressed which would negatively impact the company's ability to report its financial statements in an accurate and timely basis. Costs related to comply with Sarbanes-Oxley could also be higher than expected.[23]

Merrill Lynch also identified the "material weaknesses" in the AWW accounting controls that existed as of December 31, 2006, including:

- Inadequate internal staffing and skills
- Inadequate controls over financial reporting processes
- Inadequate controls over month-end closing processes, including account reconciliations
- Inadequate controls over maintenance of contracts and agreements
- Inadequate controls over segregation of duties and restriction of access to key accounting applications
- Inadequate controls over tax accounting and accruals[24]

C E . A detail of capital expenditures is contained in Attachment 4, covering the period 2003-2007.

P C C . For the period 2002-2007, CalAm paid out essentially 100% of its net income in dividends. The CalAm policy is to pay out 75% of net income as a common dividend. When measured against prior year income, dividends

[23] Response to OC-99. Goldman Sachs research report dated June 2, 2008, page.12.
[24] According to the report, AWW intends to be in full compliance with regulatory standards by December 31, 2009. Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 29.

for 2003-2007 were about 73%.[25] During this same period, CalAm received $25 million in capital contributions.[26]

T e PO. Based on its IPO presentation materials dated April 2008, American Water expected to sell up to 64 million shares of common stock at $24 to $26 per share, with 160 million total shares outstanding post-offering.[27] The presentation documents reflect the American Water financial policies which include:

- Target dividend policy of 50-70% of net income
- Solid investment grade rating and targeted long-term debt of 50-55%[28]

While the initial offering was expected to produce a value of $24 to $26 per share, the actual price realized was $21.50, a discount in the range of 10-20%.[29] As a result of the April 22 IPO, and a partial exercise of the greenshoe option on May 27, RWE currently holds about 60% of the AWW common stock. RWE realized approximately $1.36 billion in proceeds from the offering.[30] Many of the regulatory approvals permitting the sale of AWW shares are valid for 24 months from the time of the IPO, and as such, it is likely that RWE will further reduce its holdings during this timeframe.[31]

a a Co o o Ra g . While American Water and CalAm have represented that the divestiture of the RWE equity holding will be positive for the company and its customers, the rating agencies do not agree. In October 2007, Moody's downgraded its rating for American Water Capital Corp, making the following comments:[32]

> American Water is a parent holding company with no direct debt obligations. Its primary financing vehicle is American Water Capital Corp. ("Capital"), a finance subsidiary. American Water also incurs debt at the regulated subsidiary level.
>
> On October 12, 2007, Moody's downgraded to Baa2 from Baa1 the senior unsecured issuer rating of Capital...
>
> The downgrade of Capital's long-term rating was prompted by RWE AG's planned divestiture of the company, via initial public offering. The initial sale of RWE's interest in American Water is expected to happen in late-2007; however, preceding that transaction, Capital is expected to issue $1.5 billion of senior unsecured notes in order to substantially repay

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[25] See Attachment 5, which provides a detail of dividends and relevant income for the 2002-2007 period.
[26] Response to OC-40 Revised. 2006 -- $10 million; 2007 -- $15 million.
[27] Response to OC-31, "Final Roadshow Presentation", p.2.
[28] In its June 6, 2008 research report at page 28, Merrill Lynch noted that AWW "is targeting an A- credit rating over the long term." It also stated that its expected equity ratio would be in the 40-45% range over its forecast period through 2011. Response to Discovery OC-99.
[29] Response to OC-94. The Company was unable to identify the factors contributing to the price discount relative to expectations.
[30] Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 15.
[31] Response to OC-99. Goldman Sachs research report dated June 2, 2008, page 16.
[32] Response to OC-42; Moody's Credit Opinion dated October 17, 2007, pages 1-2.

> approximately $2.0 billion of inter-company debt currently owed to RWE. These notes are expected to be issued in October 2007. It is Moody's understanding that the company will also issue $500 million of "equity units" concurrent with the IPO that will fund out the balance of inter-company debt owed to RWE.
>
> The one-notch downgrade of Capital's senior unsecured issuer rating, and the assignment of a Baa2 issuer rating to its parent, American Water, reflects the loss of implied support from RWE following the IPO, historically weak consolidated credit metrics, and the increase in financial and operating risk going forward as a publicly traded, stand-alone company. Moody's has also taken this opportunity to equalize the new rating for American Water, a holding company, with its finance subsidiary, Capital, due to the existence of a "support agreement" between the two entities that effectively backstops Capital's timely payment of principal and interest, as needed.

While S&P did not downgrade the American Water credit ratings in October 2007 as Moody's had done, it did put the securities on CreditWatch negative. In a January 2008 Research Update, S&P stated that:[33]

> We still believe the postponement of the IPO distracts AWW's management and could stall necessary improvements to the company's financial profile, which depends on the successful execution of a number of rate cases across several states...
>
> AWW's financial metrics are weak for the rating and partly result from agreements with some state regulators not to file rate cases for up to three years. This was a condition of RWE's acquisition of AWW. As evidenced by the filing of 11 rate cases in 2007, we expect AWW to actively pursue additional rate cases as determined by its rising operating costs, capital-spending plans, and pension and other postretirement obligations...Another reason for the weak performance is AWW's significant goodwill impairments over the past three years. The impairments, which have totaled more than $1 billion, were based on slower-than-expected growth in RWE's North American water segment, privatization of water utilities in North America, and valuation of its nonregulated businesses. Based on indicative market values, an impairment of up to $300 million could be reported in fourth-quarter 2007.
>
> ...Capital expenditures are projected at $4 billion to $4.5 billion during the next five years for infrastructure replacements, new facility construction, maintenance of water-quality and environmental standards, and system reliability.

[33] Response to OC-42; S&P RatingsDirect, January 29, 2008, pages 2-3.

> With cash from operations for the past 12 months of only $390 million, AWW's cash flow generation is insufficient to meet its ongoing operating and capital needs, and will require additional access to the capital markets over the intermediate term.

In order to meet its commitment to regulators for the IPO, RWE agreed to maintain a minimum equity ratio of 45% at the time of the IPO. RWE had to contribute approximately $250 million to AWW to comply with this condition.[34] A major factor contributing to the erosion in the equity ratio, has been the substantial write-downs of recorded goodwill.

> At the time of the acquisition RWE recorded goodwill of approximately $3.4B representing the acquisition premium for AWK as well as the acquisition premium for E'Town Corporation, which had been bought by Thames Water in 2001 and was subsequently folded into AWK. Between 2004 and the first quarter of 2008, AWK recorded goodwill impairments totaling approximately $1.9B; remaining goodwill is now $1.7B.[35]

A write-off of the remaining goodwill would cause the equity ratio to decline to approximately 34% from its June 2008 level of about 47%.

The American Water Capital Corp. bond ratings for the period 2003 to 2007 were as follows:

Ta e 6 3
A e a ae Ca a Co .
E of ea
o g Te e Ra g

Year	Standard & Poor's	Moody's
2003	A	Baa1
2004	A	Baa1
2005	A-	Baa1
2006	A-	Baa1
2007	A-	Baa2
Source: Response to OC-44 (supplement dated May 11, 2008).		

On June 19, 2008, S&P lowered its corporate credit ratings for AWW to BBB+ from A-, citing a lack of cash flow improvement as the primary factor. The American Water Capital Corp. corporate credit debt securities were also downgraded to BBB+ at this time.[36] This marks the second downgrading of the company's securities by S&P in the last five years.

Sa a e O c e e e Co . The following is a summary of certain costs incurred due to the IPO, and AWW's return to being a public company.[37]

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[34] Response to OC-98. S&P Research Report Dated May 20, 2008, page 3.
[35] Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 21.
[36] Response to OC-98. S&P Research Report Dated June 19, 2008, page 2-3.
[37] Response to OC-99. Merrill Lynch research report dated June 6, 2008, page 22.

T 6 4 A C			
	2006	2007	2008
Sarbox	$15.4	$32.0	$11.2
Divestiture	7.4	8.1	7.8
T	**.8**	**40.1**	**1 .0**

C . While CalAm is required to provide the Commission with information sufficient to assure compliance with conditions imposed in both the RWE acquisition and spin-off decisions, the actual filing of relevant support is highly superficial, if not nonexistent. CalAm has represented that its customers will benefit from the spin-off. However, given the substantial pressure imposed by a capital program that exceeds cash flows available from operations, and the significant goodwill that remains on the company's books, it appears evident that the recent downgradings by S&P and Moody's indicate an erosion in financial position; not an enhancement. Regulated utilities, in the face of such conditions, generally attempt to either raise customer rates, cut costs, or both. Overland assumes that, in imposing conditions reflected in previous decisions, it did so as a basis to: evaluate the delivery of benefits represented by CalAm; and to assess, and where possible, safeguard against any potential harm to ratepayers.

The following is an illustrative review of information that the Commission may wish to require of CalAm in complying with the Conditions on Transfer of Indirect Control:

1. CalAm will be provided with adequate capital from American Water to fulfill all of its service obligations.
    - Analysis of cash flow requirements, including expected capital expenditures, dividend payments, debt refunding, etc. Representation of sources of funds aside from internally generated from operations.
    - Statement of policy regarding parent company funding, including specific financing plans necessary to meet capital requirements.
2. The transaction will not result in adverse changes in CalAm policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations.
    - Comparative analysis of number of employees by major functional categories over five-year historical period, and forecasted over three years.
    - Comparative analysis of capitalization over five-year historical period, with five-year forecast of capital structure.
    - Five-year history of changes in customer rates by district.
    - Five-year history of effective depreciation rates for jurisdictional property, including disclosure of any changes in approved rates during the period.
    - Disclosure of any changes in maintenance programs or policies over the last three years, or expected over the next three years.
3. No adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction.

- Comparative analysis of service quality, service reliability and customer satisfaction over five-year historical period.
- Comparative analysis of key measures of water quality over five-year historical period.
- Summary of all water quality violations with state or federal standards, and remediation measures taken.

4. Maintain business headquarters in California.
   - Disclosure of any offices closed, any basis for closure over three-year historical period. Indication of any closures expected over next three years.
5. No adverse impact on CalAm employees; no changes to collective bargaining agreements.
   - Statement of any adverse changes to employee compensation or benefits that conflict with employee policies and practices prior to the spin-off.
6. No changes to staffing that would result in service degradation.
7. 30 day notification of rating agency downgrades.
   - Provide five-year history of credit ratings by major rating agencies.
   - Provide detail of basis for changes in ratings.
8. No recovery of RWE spin-off transaction costs.
9. Minimum 45% equity ratio for American Water at time of IPO.
10. Affiliate agreement to remain in effect.
11. D.02-12-068 conditions to remain until RWE has sold more than 90% of its interest in American Water.

The above listing is not meant to be exhaustive, but rather an indication of the nature and extent of data that the Commission may reasonably have expected of the Company when it chose to impose these conditions.

Citizens Acquisition Premium and Synergy Savings

In D. 01-09-057, dated September 20, 2001, CalAm was authorized to acquire Citizens Water assets in California for $161.32 million, which included an acquisition premium of $64.6 million.[38] At the time of the acquisition, no independent study was performed to identify and allocate the premium with the Citizens assets acquired.[39] This premium was to be recovered in customer rates based upon a 40-year amortization, predicated, at least in part, upon a showing of synergy savings that were expected to exceed the premium. While the discussion in the decision reflects that CalAm was confident that the synergy savings estimates would be realized, the Commission recognized that there was a potential risk for overestimation.

> There are at least three ways synergies savings could be overestimated: errors in predictions of what can or will be achieved through economies of scale in operations and capital structure and/or how much value they will produce; errors in estimating the escalation, inflation and discount

[38] These amounts were subject to adjustments anticipated at the time of closing.
[39] Response to OC-101.

> methods used to extrapolate future benefits and sum them to a present value; and the possibility of long-term, significant changes that defy prediction today.[40]
>
> CalAm repeatedly acknowledged that it would have to carry the burden in future proceedings to demonstrate what synergies have been realized. CalAm also acknowledged that the Commission would be free in the future to examine whether synergies initially realized may have for whatever reason declined with the passage of time to below those initially projected. The stipulation proposal, while not permitted to extend to substantive issues which may come before the Commission in other or future proceedings, may prove a valuable reference to establish the level of synergies achieved. However, we decline in this proceeding to foreclose parties from proposing and supporting other methods and figures in a future proceeding.[41]
>
> ...CalAm would bear the burden of proving that any new or increased GRC expenses (excluding those due to inflation and customer growth) in future years were not erosions of earlier-estimated synergies.[42]

In its May 6, 2004 Sacramento District GRC Decision, the Commission found that the methodology for, and quantification of, the synergy savings was appropriate.[43] It concluded the following, based on the synergy analysis in the record.

> ...Most of the synergies savings accrue from cost of capital savings, cost of investment savings, and allocation of general office costs to Arizona; savings from other sources are small by comparison. Cost of capital savings are a primary contributor, and those arise in large part from CalAm's much lower equity ratio...We are convinced those savings do exist and came about due to CalAm's acquisition of the Citizens assets. (at page 25)

Based upon the discussion in this decision, it is clear that the Commission intended to verify and ensure that ratepayers benefited from the synergies arising from the Citizens acquisition.

> ...However, we still intend to ensure that ratepayers receive their share of the post-2004 Citizens acquisition synergies as D.01-09-057 anticipated, even if CalAm's request is granted and there is no TY2005 GRC for one or more of these districts. To accomplish that, for any Citizens districts for which there is no TY2005 GRC, revenues for service rendered on and after January 1, 2005 that are associated with the Citizens acquisition synergies savings in those districts will be made subject to refund pending

[40] D. 01-09-057; page 43.
[41] Ibid; pages 47-48.
[42] Ibid; page 48. This is also addressed in Finding h. at page 68.
[43] D. 04-05-023; pages 24-25.

a determination of what portion of the synergies savings are to be shared with customers.[44]

In its Monterey District application, CalAm has submitted an analysis estimating synergy savings associated with the purchase and operation of the Citizens' water assets located in California. The analysis of the net benefits (after consideration of the acquisition premium costs approved for rate recovery to date by the Commission) is found in the testimony and exhibits of CalAm witness David P. Stephenson.[45] The testimony and related attachments assert that CalAm operations continue to produce synergy savings at or above levels estimated in previous proceedings, based upon a previously agreed upon methodology. Based upon these representations, CalAm has requested the elimination of any further showing of the existence of merger benefits arising from the acquisition of the Citizens properties.

Re e a A a o of Me o o og . The methodology used by CalAm to quantify both its acquisition premium and the synergy savings associated with the former Citizens' properties has been subject to prior Commission review and been accepted by the ORA.[46] Therefore, the focus of our review is to confirm that the methodology continues to be followed and that the results support CalAm's claims that the synergy savings exceed the amortization of the premium paid for the Citizens' properties.

The company's current calculation of the revenue requirement of the premium and synergy savings is summarized in the following table:

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Ca fo a A e a a e
S a of Re c e Re e c of e P c a S e g Sa g
a f e e A a o o ea e Ra e e Mo e e

Year	Net Premium to Citizens Properties	Cost of Capital Savings	Cost of Investment Savings	Other Synergy Savings	Premium in Excess (Less Than) Synergy Savings
2005	$2,639,000	$1,454,697	$1,147,000	$474,933	($437,630)
2006	2,566,000	1,660,457	1,714,000	604,410	(1,412,867)
2007	2,609,500	2,492,757	2,593,000	869,568	(3,345,825)
2008	2,077,880	2,757,034	3,209,000	1,006,828	(4,894,982)
2009	2,014,740	2,965,997	3,815,000	1,299,091	(6,065,348)
2010	1,952,830	3,197,467	4,394,000	1,480,266	(7,118,903)

Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.

Consistent with its 2004 filing, the company computed an annual revenue requirement for the acquisition premium associated with the Citizens' properties of $2.6 million in 2005. This was the only year that overlapped with previously-filed data. In subsequent years, the revenue requirement decreased to $2.0 million (for the year 2010) which was due to a decrease in the total premium (net of amortization) partially offset by a reduction in the percentage allocated to the former Citizens' districts from 50% to 41%.[47] Although

[44] D. 04-05-023; page 28.
[45] Stephenson testimony, pages 28-30.
[46] CPUC Decision 04-05-023, pp. 24-26.
[47] Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District.

significant, it should be noted that amounts allocated to the former CalAm districts were not incorporated in the following synergy savings analysis prepared by the company.[48]

The synergy savings calculated by the company were driven largely by two components – the cost of capital savings and the cost of investment savings. These two were previously identified by the Commission in its decision approving the recovery of synergies (D.04-05-023).[49] Although the total synergy savings also incorporate expected differences in the levels of costs associated with a CalAm-managed company versus a Citizens-run company, these savings are relatively insignificant.

The company's calculated cost of capital savings are a function of expected differences between the weighted average cost of capital (WACC) of CalAm and Citizens.[50] These expected differences in WACC are multiplied by rate base to derive the savings. Without regard to income tax impacts, WACC is calculated as follows:

WACC = (% of Debt Financing x Cost of Debt) + (% of Preferred Stock Financing x Cost of Preferred Stock) + (% of Common Equity Financing x Cost of Common Equity)

The WACC inputs assumed by the company for this calculation are summarized in the following table:

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Description	Citizens	CalAm
% of Debt Financing	46.25% - 49.39%	65.00%
Cost of Debt	7.07% - 7.75%	5.17% - 6.25%
% of Preferred Stock Financing	2.36% - 5.50%	0,00%
Cost of Preferred Stock	5.31%	N.A.
% of Common Equity Financing	48.25%	35.00%
Cost of Common Equity	9.95% - 10.00%	9.95% - 10.00%
Pre-Tax Gross Up Factor	1.79	1.79
Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.		

Primarily because CalAm projected that it would employ more debt financing than Citizens at a significantly more attractive rate than Citizens could obtain, the pre-tax WACC savings estimated by CalAm were as follows:

[48] The primary drivers of synergy benefits in the Citizens' districts, namely improved productivity in construction practices and saving in the cost of capital, would not be applicable in an assessment of benefits in the CalAm districts.

[49] CPUC Decision 04-05-023, p. 25 (dated May 6, 2004).

[50] The Citizens authorized rate of return prior to the American Water acquisition was 8.18%, which included an embedded cost of debt of 7.07%. Response to OC-47; CPUC Decision 98-10-056, dated October 22,1998.

Ta e 6 Ca fo a A e a a e Co a Co a o of ACC Sa g			
Year	Citizens	CalAm	WACC Savings Under CalAm
2005	12.39%	9.81%	2.58%
2006	12.38%	9.72%	2.66%
2007	12.36%	9.94%	2.42%
2008	12.42%	9.97%	2.45%
2009	12.40%	9.97%	2.43%
2010	12.41%	9.98%	2.43%

Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.

The other primary driver of synergy savings is the cost of investment savings. This is derived by the company by comparing the presumed construction expenditures under both Citizens and CalAm management, multiplied by the pre-merger Citizens' WACC.

Underlying this synergy savings component is an assumption by CalAm that it is able to complete a capital project more efficiently than Citizens. For instance, CalAm projects that it can do the Conversion of Flat Rate to Metered Service Connections (Investment Item No. 056002-09) less expensively than Citizens by nearly $12.3 million over a 6-year period (2005-2010). This equates to an approximate 43% discount before overhead loadings when compared to Citizens' projected costs.[51]

The most significant investment savings were derived from the following projects:

Ta e 6 8 Ca fo a A e a a e P o e e Ca a E e e Sa g P o e				
Year	Conversion of Flat Rate to Metered Service Connections (056002-09)	Construct Distribution Service Improvements (Suburban Area) (056002-02)	Small Main Replacement Program – Shenandoah (056002-15)	Arsenic Treatment
2005	$1,991,641	$563	$567,938	$104,695
2006	2,154,963	9,017	602,119	266,659
2007	2,336,451	798,830	610,312	495,944
2008	1,953,750	550,000	575,000	--
2009	1,905,000	625,000	577,500	--
2010	1,929,375	587,500	576,250	--

Source: Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application, some summing required.

Additionally, CalAm assumes that Citizens' overheads to be applied to capital projects are approximately 8% more than its own. This assumption results in an additional $11.2 million of capital costs "saved" by CalAm over the 2005-2010 timeframe.[52]

[51] Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application, some summing required.
[52] Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application, some summing required.

To test the sensitivity of these key assumptions on projected synergy savings, Overland recalculated the results with more conservative assumptions, including cost of capital savings and cost of investment savings that ranged from one-fourth to one-half of the spreads assumed by the company. Recalculations of the savings were each run independently of one another and are summarized along with the company's original calculation in the table below:

Ta e 6
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Re e e Re e e of e A o P e E e e T a S e g Sa g

Year	Company Calculation	50% of Cost of Capital Savings	25% of Cost of Capital Savings	50% of Cost of Investment Savings	25% of Cost of Investment Savings
2005	($437,630)	$289,719	$650,574	$292,917	$657,290
2006	(1,412,867)	(582,639)	(170,645)	(333,139)	207,325
2007	(3,345,825)	(2,099,447)	(1,481,408)	(1,735,632)	(929,435)
2008	(4,894,982)	(3,522,092)	(2,824,393)	(2,879,669)	(1,872,412)
2009	(6,065,348)	(4,588,453)	(3,843,902)	(3,664,356)	(2,464,760)
2010	(7,118,903)	(5,526,749)	(4,724,092)	(4,345,372)	(2,958,006)

Note: Company calculation obtained from Attachment 1 to the Direct Testimony of David P. Stephenson in the Monterey District Application.

Even with more conservative assumptions, the calculated synergy savings over the 6-year period from 2005 to 2010 exceed the revenue requirement of the acquisition premium using the methodology previously reviewed by the Commission.

Finally, Overland considered the effect of the Commission's implicit requirement that CalAm maintain a minimum 45% equity ratio.[53] In deriving its imputed benefits for the Citizen's districts, CalAm has continued to use a 35% equity ratio. While substitution of a 45% equity ratio does reduce the implied synergy savings, it does not eliminate them.

Co a a e A a . Attachment 6 provides a comparative income statement for CalAm. Operation and maintenance expenses have risen by approximately 38% over the five-year period 2003-2007, while inflation during this period was approximately 13% and 16%, as measured by the CPI and PPI price indices, respectively.

Ta e 6 10
Ca fo a A e a a e
O M E e e e C o e

Year	O&M Expense (A)	Number of Customers (B)	O&M Expense per Customer (C)
2003	$67,374,280	167,834	$401
2004	72,859,724	170,195	428
2005	88,863,117	169,358	525
2006	85,318,015	169,475	503
2007	93,013,029	169,196	550

Sources: Column (A) – Response to OC-35, Column (B) – 2003-2006 obtained from Exhibit B: Chapter 9: Section 1: Table 6 of the CalAm General Office Application and 2007 was obtained from the response to OC-90, Column (C) = Column (A) divided by Column (B).

[53] Decision 07-05-031 dated May 3, 2007, Appendix A, Condition 9. CalAm is required to maintain a 45-55% equity ratio.

During this period, customer rates were modified as follows:

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Date Filed	Effective Date	General Rate Case Amount	General Rate Case Percent	Riders Amount	Subject Matter
2/1/2003	2/23/2003	$2,642,100	10.36%		GRC Rates
3/14/2003	6/10/2003			$849,314	Recovery of WRAM Balancing Account
6/25/2003				$1,122,653	Recovery of Conservation Balancing Account
4/27/2004	11/24/2004			-$458,383	WRAM Balancing Account - Refund over collection
11/10/2004	1/6/2005	$948,400	3.3%		Step Rate Increase
5/11/2005		$710,302	2.44%		Recovery of Plan B - Surcharge
4/4/2006	5/5/2006			-$3,429,045	Refund over collection in WRAM account
12/20/2006	1/1/2007			$2,993,260	Surcharge - Coastal Water Project
3/2/2007	4/6/2007			$3,023,971	True up interim rates per D.06-11-050 --Surcharge
11/16/2007	1/1/2008	$752,700	2.30%		Step Rate Increase - 2008
5/15/2008	5/8/2008			-$3,116,173	WRAM Balancing Account - Refund over collection

Source: Response to OC-157

Sale of Felton Properties

CalAm has entered into an agreement to sell the Felton water properties to the San Lorenzo Valley Water District for $10.5 million in cash, and assume $2.9 million in debt for the Kirby Street water treatment plant secured by state loans. As part of the transaction, CalAm will also donate 250 acres of forested watershed land.[54] In order to address matters of potential relevance to the Commission associated with this transaction, Overland issued discovery to gain more detailed information than contained in the Settlement Agreement itself.[55] However, given the refusal of CalAm to produce information needed to provide the Commission with an analysis necessary to consider the potential implications of the sale on CalAm customer rates, we must confine the discussion to the application of Commission policy, supplemented with hypothetical estimates.

CPUC Po Rega g e T ea e of a f o e Sa e of U A e . The Commission has addressed its policy regarding the treatment of gains or losses from the sale of property in a number of cases. The following is a brief summary of these decisions, and their applicability to the specific facts associated with the sale of the Felton assets.

In R.04-09-003, the Commission Order dated September 2, 2004, established guidelines for recognition and allocation of gains on the sale of public utility property. It considered these guidelines based on various objectives including:[56]

[54] Response to OC-149; Settlement Agreement (After Mediation) dated May 27, 2008.
[55] CalAm refused to provide detailed information regarding the property valuation, or accounting and tax implications of the sale of the Felton properties as contained in : OC-151, 152, and 155, issued July 15, 2008.
[56] R.04-09-003, pages 4-5.

- These guidelines should apply to the allocation of both gains and losses upon the sale of a capital asset.
- The allocation should vary directly, holding everything else constant, with the assumption of the financial risk of the investment.
- While it is important to ensure that ratepayers are not harmed by the sale of the asset, or that they are compensated if they are, it is equally important to recognize who has borne the burden of the financial risk of the investment.
- For the majority of cases, ratepayers have borne most of the financial risk and have paid for the asset. Thus it will be typical for most of the gain to be allocated to the ratepayer. The burden of the financial risk should be a primary consideration whenever the gain is allocated between ratepayer and shareholder.
- The allocation of the gain on sale standards should provide an incentive to encourage prudent management of utility assets.

The Rulemaking references provisions of the Utility Code specific to the treatment of gains of water utility assets.[57]

> In 1995, Pub. Util. Code §§ 789 *et seq.* was enacted, which provides that a water corporation shall invest the "net proceeds" of the sale of real property in water system infrastructure that is necessary or useful for utility service. This rule effectively allocates the entire gain from the sale of an asset to shareholders if it is reinvested toward a public purpose. The gain is added to the utility's ratebase on which the shareholders earn a rate of return through rates paid by the ratepayers.

The Rulemaking also references decisions regarding the sale of a portion of a distribution system to a municipality – specifically, a segment of the PG&E distribution properties to the City of Redding. In D.85-11-018, the Commission originally found that the gain from sale of the distribution assets were assignable to ratepayers based upon recognition of relative risk. However, this policy was reversed in a subsequent Decision that has come to be referred to as "Redding II", summarized by the Commission in the Rulemaking as follows.[58]

> The result obtained in D.85-011-018 was essentially reversed in D.89-07-016. We used two standards to allocate the gain: 1) whether the ratepayers were harmed by the transaction leading to the gain, and 2) whether ratepayers had contributed capital to the acquisition of the asset. We stressed that these standards applied to the particular circumstances of this sale only.(9) We concluded that, under these standards, the gain should be allocated to the shareholders. ***If either of these standards had not been met, the gain could have been used to mitigate the harm to ratepayers or repay their contributed capital...*** (emphasis added)

[57] Ibid; page 7.

[58] R.04-09-003, page 21. Within the above quote, the referenced footnote stated: "sale of part of a public utility distribution system to a public entity which then assumes the obligation to serve the customers formerly served by the utility within the area served by the transferred system."

The Rulemaking recognized potential implications of the Water Utility Infrastructure Improvement Act of 1995, Public Utilities Code §§ 789 *et seq.*, including consideration of the sale of property no longer used or useful in providing water utility service. The Code provided for the potential retention of such gains, with a requirement for utility reinvestment in utility property. The Commission was concerned with the potential applicability of Code §§ 789 and § 790, stating various reasons, including the following.[59] [60]

> We also believe the statute may require further interpretation regarding water utility assets originally obtained from sources other than the utility shareholders.

Aside from the specific conditions referenced above for sales of distributions systems and Code guidelines for water property sales, the Commission addressed general guidelines for the allocation of gains that included.[61]

- The Allocation should vary directly, holding everything else constant, with the assumption of the financial risk of the investment.
- While it is important to ensure that ratepayers are not harmed by the sale of the asset, or that they are compensated if they are, it is equally important to recognize who has borne the burden of the financial risk of the investment.
- For the majority of cases, ratepayers have borne most of the financial risk and have paid for the asset. Thus it will be typical for most of the gain to be allocated to the ratepayer. The burden of the financial risk should be a primary consideration whenever the gain is allocated between ratepayer and shareholder.

In an effort to provide a general standard for the treatment of utility gains and losses, the Commission issued Decision 06-05-041, dated May 25, 2006. The general rules provided by this Decision are to apply if the sale price is $50 million or less and the after-tax gain or loss is $10 million or less. The Commission found that, unless there was an exception from the general rule established in the Decision, that ratepayers should receive 100% of gains from the sale of depreciable property.[62] This Decision continued to uphold its Redding II ratepayer harm test, stating:[63]

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[59] Ibid; pages 26-31. See also Finding 39 at page 51.

[60] In D.07-09-021, dated September 6, 2007, Opinion Regarding Gains on Sale of Utility Assets (Phase Two) – Issues Not Resolved in Decision 06-05-041, the Commission clarified its position on certain matters previously left open. Among other things, it addressed the treatment of gains due to the condemnation of water utility assets, wherein it concluded that such transactions are no different in character than other sales of property that are no longer used or useful under Section 790 (pages 24-27).

[61] Ibid; pages 39-40.

[62] D.06-05-041, pages 2-3. At page 96, the Commission found that ratepayers should receive 50% of gains or losses on the sale of non-depreciable utility assets. This was subsequently modified in D.06-12-043 (page 16), to provide for an allocation of 67% of gains to ratepayers for non-depreciable assets.

[63] Ibid; page 32. The Commission's position on Redding II was reaffirmed in D-06-043, dated December 14, 2006, page 15.

> We will continue to apply the *Redding II* principles in the narrow circumstances to which they were designed to apply. Thus, where (1) a public utility sells a distribution system to a governmental entity, (2) the distribution system consists of part or all of the utility operating system located within a geographically defined area, (3) the components of the system are or have been included in the rate base of the utility, and (4) the sale of the system is concurrent with the utility being relieved of, and the governmental entity assuming, the public utility obligations to the customers within the area served by the system, then the gains or losses from the sale of the system should be allocated to utility shareholders, provided that the ratepayers have not contributed capital to the distribution system and remaining ratepayers are not adversely affected by the transfer of the system. We have not been presented with an adequate record to justify broadening or narrowing *Redding II's* scope.

While the general application of the current Commission policy for the allocation of gains from the sale of a utility operating system would indicate an allocation to shareholders, we believe that the specific facts and circumstances of the Felton transaction, upon its review, should lead the Commission to consider otherwise. These properties were a component of the assets acquired by CalAm in 2002. As previously addressed, the CPUC granted the recovery in customer rates of a $64.5 million premium associated with the Citizens assets, including the Felton district. No independent study or internal analysis was performed to identify the fair value of the Citizens properties acquired, or the specific values of particular districts.[64] For ratemaking purposes, CalAm has allocated the acquisition premium to Citizens districts on the basis of customers. This implicitly assumes that the relationship of fair value (the purchase price of the Citizens properties) to the underlying book value is uniform among the districts acquired. However, there is no reason to believe that this would be the case. Further, present market conditions have eroded relative to the timeframe in which the Citizens acquisition occurred. Thus, the market value of the Felton properties can reasonably be assumed to have been higher at the time they were acquired by CalAm than is indicated by the recent transaction.

Consistent with existing precedent, Felton customers are likely to pay rates that reflect the acquisition costs of the water assets acquired. However, unless the Commission reduces the Citizens acquisition premium by the gain on the sale of the Felton properties, the unintended consequence will be the ongoing recovery of most of the fair value over book value of the Felton properties in the CalAm customer rates.

g a Co o . In its Monterey filing now pending, CalAm witness David Stephenson addresses the company's request to cease any future requirement to support the level of synergy savings relative to acquisition costs in rates.[65] The analysis performed by CalAm generally conforms to the methodology agreed upon and approved in previous proceedings. Overland has tested the CalAm results filed in the current Monterey application, and has found that positive results are realized, even under much

[64] Response to OC-101.
[65] Direct Testimony of David P. Stephenson, pages 28-30.

more conservative assumptions. As more time elapses from the time of the CalAm acquisition of these properties, the application of any methodology becomes more difficult to use as a reliable estimate, as such estimates must be based upon a hypothetical case that assumes a theoretical conditions under a continued Citizens ownership and operation of the properties. For these reasons, we concur that CalAm need not be required to impute synergy benefits to support its acquisition premium in future cases.

With regard to the gain from the sale of the Felton properties, we believe that the facts and circumstances associated with this transaction, in light of the acquisition premium in current CalAm rates that are potentially attributable to these properties, now warrants further Commission scrutiny. We believe that the gain on these properties may be in the range of $5-6 million.[66] It is clear that the Commission reserves the right of review for the disposition of utility property; particularly in case-specific circumstances where its general policy may not apply. Given our previous discussion on this subject, it may be appropriate to reduce the current acquisition premium by the gain realized in the Felton transaction. However, without more detailed information, we cannot make any final recommendations at this time.

[66] The Company has refused to produce specific information that would provide details regarding to actual gain on the Felton transaction. General market indicators support a market-to-book ratio of about 2x. However, actual transaction data may vary materially from this general assumption.

APPENDIX A

ADOPTED
CALIFORNIA-AMERICAN WATER COMPANY
CONDITIONS ON TRANSFER OF INDIRECT CONTROL

1. California-American Water Company (Cal-Am) will be provided with adequate capital from American Water Works Company, Inc. (American Water) to fulfill all of its service obligations prescribed by the Commission and Cal-Am.

2. American Water and Cal-Am shall ensure the transaction will not result in any adverse changes in Cal-Am policies with respect to service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations.

3. American Water and Cal-Am will ensure that there is no adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction.

4. Cal-Am will continue to maintain its business headquarters in California together with field offices as appropriate to maintain the quality of service. Cal-Am will not close any of its local offices as a result of his transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transactions or which would have occurred absent the transaction.

5. The transaction will have no adverse impact on Cal-Am employees and there will be no changes in any existing union agreements as a result of the transaction. All collective bargaining agreements will continue to be honored.

6. Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction.

7. American Water and American Water Capital Corporation (AWCC) will notify the Commission in writing within 30 days of public notification to American Water or AWCC of any downgrading to the bonds of American Water or AWCC and will include with such notice the complete report from the issuing bonding rating agency.

8. American Water will make no attempt to recover through Cal-Am's rates any of the transaction costs arising from the divestiture by RWE Aktiengesellschaft (RWE) and Thames Water Aqua Holdings GmbH (Thames GmbH) of American Water, including the Securities and Exchange registration fee, the National Association of Securities Dealer filing fee, the stock exchange listing fee, legal fees and costs of the proposed transaction, accounting fees and expenses of the proposed transaction, printing and engraving fees and expenses for the registration statement, Blue Sky fees and expenses, transfer agent fees and expenses, legal fees for the state regulatory approval process, and the costs of implementing the initial process and controls for compliance with the Sarbanes-Oxley Act of 2002. Cal-Am will not at any time seek to recover from its ratepayers costs directly incurred as a result of the proposed transaction from ratepayers of Cal-Am; however, Cal-Am may seek recovery of legitimate ongoing, non-startup costs of being a publicly traded company in future general rate proceedings.

9. RWE will provide an equity investment to American Water at the time of the proposed initial public offering to ensure that American Water has a capital structure in the range of 45% to 55%, with a minimum of 45% common equity.

10. All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. Additionally, the Affiliate Transaction Rules that were agreed to as part of the Settlement Conditions in Decision

(D.) 02-12-068 will continue. The references to RWE and RWE Group will be removed once RWE no longer has a 10% controlling interest in American Water.

11. None of the acquisition conditions from D.02-12-068 should be removed until RWE (or its subsidiaries or affiliates) has sold more than 90% of its interest in American Water. Where RWE and its affiliates cumulatively have more than 10% but less than 50% interest in American Water and find themselves in a minority position and unable to comply with any of the conditions set forth in Appendix C, Cal-Am should file an application explaining why RWE or its subsidiaries cannot comply with the condition and request an exemption from the condition.

(END OF APPENDIX A)

APPENDIX C

APPLICATION NO: A.06-05-025
JOINT APPLICANTS: RWE AKTIENGESELLSCHAFT, THAMES WATER AQUA HOLDINGS GMBH, AMERICAN WATER WORKS COMPANY, INC., CALIFORNIA-AMERICAN WATER COMPANY

LATE-FILED EXHIBIT __

CONDITIONS IMPOSED IN D.02-12-068

Number[1]	CONDITION IMPOSED IN D. 02-12-068 PURSUANT TO SETTLEMENT AGREEMENT	JOINT APPLICANTS' PROPOSED REMOVAL OF OR MODIFICATION TO CONDITION	ANALOGOUS CONDITION PROPOSED BY DRA IN THIS PROCEEDING
1	Cal-Am agrees to the following: Monterey: defer filing the authorized 2004 step rate increase that would have been filed in 2003 to November 2004 to be effective January 2005. Sacramento, Felton, Montara and Larkfield: defer filing the authorized 2004 step rate increase that would have been filed in 2003 to November 2004 to be effective January 2005. Los Angeles (San Marino, Duarte and Baldwin Hills): file general rate case as scheduled in 2003 but set forth in the application that Cal-Am will defer filing the tariffs authorizing rate increases from January 1, 2004 to January 1, 2005. This deferral will not apply to any step rates. Village & Coronado: file	Fully executed; not applicable going forward. See endnote.	Proposed Condition No. 15.

[1] The number of each condition refers to each condition as numbered in Appendix B to D. 02-12-068 entitled "Settlement Agreement With Conditions."

	general rate case as scheduled in 2004 but set forth in the application that Cal-Am will defer filing the tariffs authorizing rate increases from January 1, 2005 to January 1, 2006. This deferral will not apply to any step rates. Any such deferred rates will be placed into effect at the same time as the next scheduled step rate for each such district.		
2	Cal-Am will be provided with adequate capital to fulfill all of its service obligations prescribed by the Commission and Cal-Am will comply with all applicable California and federal statutes, laws and administrative regulations.	Cal-Am will be provided with adequate capital from American Water to fulfill all of its service obligations prescribed by the Commission and Cal-Am. (Condition No. 1)	Proposed Condition No. 1
3	The Commission will retain jurisdiction over the rates and services provided by Cal-Am. RWE, Thames, American and Cal-Am will not assert in any Commission proceeding that Commission review of the reasonableness of any cost has been or is preempted by a United Kingdom, Federal Republic of Germany, European Community or other foreign regulator.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
4	Cal-Am will continue to maintain its books and records in accordance with all Commission rules. Cal-Am's books and records will be maintained and housed in California.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
5	The transaction will not result in any adverse changes in Cal-Am policies with respect to service to customers, employees, operations,	American Water and Cal-Am shall ensure the transaction will not result in any adverse changes in Cal-Am policies with respect to	Proposed Condition No. 2

	financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest or utility operations.	service to customers, employees, operations, financing, accounting, capitalization, rates, depreciation, maintenance, or other matters affecting the public interest of utility operations. (Condition No. 2)	
6	There will no adverse impact on customer service as a result of the transaction. RWE and Thames will maintain American's and Cal-Am's levels of commitment to high quality utility service and will fully support maintaining Cal-Am's record for service quality.	American Water and Cal-Am will ensure that there is no adverse impact on the quality of customer service, water quality, and reliability as a result of the transaction. (Condition No. 3)	Proposed Condition No. 3.
7	Cal-Am shall continue to maintain its business headquarters in California together with fully operational field offices as appropriate to maintain the quality of its service. Cal-Am will not close any of its local offices as a result of this transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transactions.	Cal-Am will continue to maintain its business headquarters in California together with full operational field offices as appropriate to maintain the quality of its service. Cal-Am will not close any of its local offices as a result of this transaction. However, Cal-Am is not precluded from making local operational changes in connection with integrating water and wastewater systems acquired in other transaction **<u>or which would have occurred absent the transaction</u>**. (Condition No. 4)	Proposed Condition No. 4.
8	The transaction will not result in changes to the existing management and officers of Cal-Am.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
9	Operational control of Cal-Am will not change as a result of the transaction.	Covered by Condition No. 4. No longer warranted; condition should be removed.	Not addressed in DRA Report.
10	The transaction will have no adverse impact	The transaction will have no adverse impact on	Proposed Condition No. 5.

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	on Cal-Am employees. Thames has committed to no layoffs until March 31, 2004 or one year after the transaction closes, whichever is later. There will be no changes in compensation and the value of employee benefits will not diminish as a result of the transaction.	Cal-Am employees and there will be no changes in any existing union agreements as a result of the transaction. All collective bargaining agreements will continue to be honored. (Condition No. 5)	
11	There will be no changes in any existing union agreement as a result of the transaction. All collective bargaining agreements will be honored.	Covered by Condition No. 5.	Proposed Condition No. 5.
12	Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction.	Cal-Am will not allow the transaction to diminish staffing that would result in service degradation. However, Cal-Am may make local staffing and other operating changes which would have occurred absent the transaction. (Condition No. 6)	Proposed Condition No. 6.
13	There will not be an additional layer of management overhead allocated to Cal-Am as a result of the transaction. Cal-Am may, however, demonstrate in a rate proceeding that specific management overheads provide a benefit to Cal-Am or its customers and should be recoverable in rates.	No longer warranted; condition should be removed. See endnote.	Not addressed in DRA Report.
14	None of the outstanding debt, owed and recorded as liabilities on the books of Cal-Am, will be affected by the proposed transaction. There will be no changes in the income statement, balance sheet or financial position of Cal-Am as a result of the transaction.	No longer warranted; condition should be removed. See endnote.	Not addressed in DRA Report.

15	Cal-Am's equity to capital ratio shall be maintained at or about 35 percent. If Cal-Am's common equity falls below 35 percent of total capital, Cal-Am shall within 30 days of such event provide a detailed written plan of action to return Cal-Am's equity capital to a minimum of 35 percent. In general rate cases the Commission has historically authorized a capital structure for Cal-Am composed of approximately 55-60% debt and 40-45% equity. Cal-Am shall not be prohibited from requesting that the foregoing equity percentage be modified based on changes in capital markets or other conditions that make it prudent to alter Cal-Am's capital structure.	No longer warranted; condition should be removed. See endnote.	Not addressed in DRA Report.
16	RWE and American Water Capital Corporation (AWCC) will notify the Commission in writing within 30 days of any downgrading to the bonds of RWE or AWCC and will include with such notice the complete report of the issuing bonding rating agency.	American Water and American Water Capital Corporation will notify the Commission in writing within 30 days **of public notification to American Water or AWCC** of any downgrading to the bonds of American Water or AWCC and will include with such notice the complete report of the issuing bonding rating agency. (Condition No. 7)	Proposed Condition No. 7.
17	Neither Cal-Am nor its ratepayers, directly or indirectly, will incur any transaction costs or other liabilities or obligations arising from Thames' and RWE's acquisition of American. All costs of the transaction will be absorbed by the shareholders with no attempt to seek recovery from ratepayers at any time. Cal-Am will not incur any additional indebtedness, issue any additional securities, or pledge any	**American Water will make no attempt to recover through California American Water's rates any of the transaction costs arising from the divestiture by RWE and Thames GmbH of American Water, including the SEC registration fee, the NASD filing fee, the stock exchange listing fee, legal fees and costs of the Proposed Transaction, accounting fees and expenses of the Proposed**	Proposed Condition No. 8.

	assets to finance any part of the purchase price paid by Thames for American stock.	**<u>Transaction, printing and engraving fees and expenses for the registration statement, Blue Sky fees and expenses, transfer agent fees and expenses, legal fees for the state regulatory approval process, and the costs of implementing the initial processes and controls for compliance with the Sarbanes-Oxley Act of 2002. California American Water will not at any time seek to recover from its ratepayers costs directly incurred as a result of the Proposed Transaction from ratepayers of California American Water; however, California American Water may seek recovery of legitimate ongoing, non-startup costs of being a publicly-traded company in future general rate cases.</u>** (Condition No. 8)	
18	The premium Thames pays for American stock, as well as all transaction-related costs, including external advisors, early termination costs, change in control payments, or retention bonuses paid to Cal-Am or American employees as a result of the proposed transaction, will not be "pushed down" to Cal-Am, and there will be no attempt to recover such costs in any future rate proceeding.	Covered by Condition No. 8, as modified by Joint Applicants.	Proposed Condition No. 8.
19	For a period of five years following the close of the transaction Cal-Am will not seek a cost of new debt greater than it would have sought if American had remained an independent entity. For the purposes of this provision, Cal-Am agrees that at present its cost of new debt	No longer warranted; condition should be removed. See endnote.	Proposed Condition No. 9.

	is based on AWCC's current Standard and Poor's credit rating of A- for secured debt and current Moody's credit rating of Baal, for senior unsecured debt.		
20	For a period sufficient to cover a single full rate cycle for each of Cal-Am's four sets of filing districts, not to exceed four years from the date of closing, RWE, Thames, American and Cal-Am will implement a mechanism to track the savings and costs resulting from the proposed merger and a methodology to allocate all net savings and will submit to the Commission in writing a detailed description of that methodology in connection with future Cal-Am general rate case filings.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
21	Cal-Am will provide the Commission with English-language versions of the RWE annual reports, RWE quarterly shareholder reports and the annual audit reports of RWE, Thames, American and Cal-Am, as applicable, either in printed media or through access to electronic versions. In addition, the income statement, balance sheet, and statement of cash flows will be converted to U.S. dollars at the exchange rates existing at the end of the time period for such excerpts or financial reports.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
22	Cal-Am will match in its future rate proceedings the cost of any "best practices" that are implemented with a reasonable estimate of the savings or increased revenues that will result from the implementation of such practices and will not implement the	No longer warranted; condition should be removed.	Not addressed in DRA Report.

	practices if the increased revenues or decreased expenses do not justifiably exceed the cost of such practices. When implementing best practices, RWE, Thames, American and Cal-Am will take into full consideration the related impacts on the levels of customer service and customer satisfaction, including any negative impacts resulting from any future work force reductions.		
23	Thames will commit shareholder funds up to $50,000 annually for a five-year period from the close of the transaction to develop, promote or otherwise get a low-income assistance program underway in cooperation with the Commission. Cal-Am will not seek recovery of those contributions to a low-income assistance program from ratepayers. Applicants shall spend the fully allocated annual sum for this program even if the funds are not expended during the five-year period.	No longer warranted; California American Water will honor its existing commitment.	Proposed Condition No. 16.
24	Thames will commit shareholder funds up to $50,000 annually for a five-year period from the close of the transaction to establish in cooperation with the Commission a Small System Technical Advisory Team (SSTAT) by Cal-Am within six months of the close of the transaction. Cal-Am will not seek recovery of those contributions for a SSTAT from ratepayers. Applicants shall spend the fully allocated annual sum for this program even if the funds are not expended during the five-year period.	No longer warranted; California American Water will honor its existing commitment.	Proposed Condition No. 17.

25	The Commission has approved Cal-Am's agreements with affiliates American Water Works Service Company and American Water Capital Corp. All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. The Affiliated Transaction Rules attached as Appendix A shall apply to Cal-Am affiliated transactions not now covered by existing Commission-approved affiliated transactions.	All affiliated interest agreements approved by the Commission to which Cal-Am is a party will remain in effect. Additionally, the Affiliated Transaction Rules that were agreed to as part of the Settlement Conditions in D.02-12-068 will continue. The references to RWE and RWE Group will be removed once RWE no longer has a controlling interest in American Water. (Condition No. 12)	Proposed Condition No. 12.
26	Historically, Cal-Am has transferred on a quarterly basis approximately 75% of its net income to its parent, American Water Works Company, Inc., as a dividend. If Cal-Am's payment of any dividend or transfer of any funds to American represents more than the historical percentage of Cal-Am's annual net income, then Cal-Am will notify the Commission of that fact.	No longer warranted; condition should be removed.	Not addressed in DRA Report.
27	Cal-Am's parent and affiliates will not acquire Cal-Am assets at any price if such transfer of assets would impair the utility's ability to fulfill its obligation to serve or to operate in a prudent and efficient manner.	No longer warranted; condition should be removed. Also covered by Condition No. 12, as modified by Joint Applicants.	Not addressed in DRA Report.
28	The creation of Thames Water Aqua U.S. Holdings, Inc., by RWE will have no adverse impact on Cal-Am from an operating, financial or management perspective.	No longer warranted; part of a complete agreement between parties to a different proceeding; condition should be removed.	Not addressed in DRA Report.
29	Cal-Am will seek to employ Thames' advanced project delivery experience to compliment American's capability. Based on	No longer warranted; part of a complete agreement between parties to a different proceeding; condition should be removed.	Not addressed in DRA Report.

	Cal-Am's forecasted capital expenditures for a full rate cycle for Cal-Am's filing districts, Applicants believe such savings would reduce its capital expenditure requirements by about $2.2 million.		

ENDNOTE: The continuation of Condition Nos. 1, 13, 14, 15 raise issues that are more appropriately addressed in general rate case proceedings and would assure a financially weakened American Water and California American Water, directly contrary to the public interest.

(END OF APPENDIX C)

Water Quality Results 2003-2007
California American Water Company
Monterey

Substance:	Gross Alpha Particle Activity (pCi/L)		Combined Radium (pCi/L)		Uranium (pCi/L) (1)		Arsenic (ppb)		Fluoride (ppm)		Nitrate as NO3 (ppm)		Selenium (ppb)	
Reporting year	MCL	Average Amount Detected	MCL	Average Amount Detected	MCL	Average Amount Detected	MCL (2)	Average Amount Detected	MCL	Average Amount Detected	MCL (3)	Average Amount Detected	MCL	Average Amount Detected
2003	15	3.44	5	1.53	NR	NR	50	ND	2	0.22	45	17	50	7
2004	15	3.44	5	1.53	NR	NR	50	ND	2	0.23	45	4.8	50	5
2005	15	3.44	5	1.53	NR	NR	50	ND	2	0.20	45	2.04	50	ND
2006	15	1.18	5	ND	20	ND	10	ND	2	0.20	45	21.4	50	ND
2007	15	0.95	5	<1.0	20	0.79	50	10	2	0.26	45	16	50	20

	Total Trihalomethanes (TTHM) (ppb)		Halocetic Acids (ppb)		Chlorine (ppm)		Copper (ppm)		Lead (ppb)		Total Coliform Bacteria	
	MCL (5)	Results	MCL	Results	MRDL as Cl2	Results	Action Level	Amount Detected at 90th %ile	Action Level	Amount Detected at 90th %ile	MCL	Highest Percentage Detected.
2003	80	36.5	60	18.1	4.0	1.58	1.3	0.364	15	2	NR	NR
2004	100	31.5	60	14.4	4.0	1.45	1.3	0.364	15	0.002	NR	NR
2005	100	33	60	18.7	4.0	1.37	1.3	0.364	15	0.002	(4)	0.57
2006	100	36.6	60	16.4	4.0	1.18	1.3	0.618	15	5	(4)	0.57
2007	100	34	60	14	4.0	1.09	1.3	0.364	15	0.002	(4)	0.57

MCL = Maximum contaminant level, unless otherwise noted, is based on U.S. Envrionmental Protection Agency standards

MRDL = Maximum residual disinfectant level. The level of disinfectant added for water treatment that may not be exceeded at the consumer's tap.

NR = Not included in report for that year

ND = Not detected

pCi/L (picocuries per liter) Measurement of the natural rate of disintegration of radioactive contaminants in water (also beta particles).

ppb = parts per billion

ppm = parts per million

1 - In California the MCL for Uranium is reported as pCi/L. MCL per the U.S. EPA is 30 mcg/L (micrograms/liter). The conversion factor used is 0.67pCi/mcg

2 - Effective 1/23/06 the U.S. EPA MCL for Arsenic is 0.010mg/L (10 ppb.) At the time of reporting, the state of California MCL remained at 0.050mg/L (50 ppb), and the new standard had not yet been adopted.

3 - Reported MCL standard of 45 milligrams per liter (mg/L) for nitrate as NO3 is equivalent to U.S. EPA standard of 10 mg/L for nitrate as N.

4 - MCL for Total Coliform Bacteria (systems that collect 40 or more samples/month) more than 5%of monthly samples are positive; (systems that collect less than 40 samples/month), no more than 1 positive monthly sample.

5 - Standard MCL for TTHM is 80ppb for both California as of 6/17/06 and the U.S. EPA as of 1/1/02. 100ppb is listed on reports.

California American Water Company
Capital Expenditures

	2003	2004	2005	2006	2007	Cumulative
Los Angeles (LA)	3,293,847	3,227,836	4,844,127	2,546,565	4,513,360	18,425,735
Coronado (COR)	198,778	407,746	1,310,109	849,092	1,362,768	4,128,493
Corporate (CORP)	340,971	802,269	724,485	91,552	139,151	2,098,428
Felton (FEL)	347,740	576,679	159,438	179,850	(36,314)	1,227,393
Ventura (VEN)	348,147	2,530,619	4,083,831	(103,665)	6,136,376	12,995,307
Larkfield	742,379	1,490,984	697,638	1,507,734	1,002,470	5,441,205
Monterey	11,002,394	19,941,978	14,108,026	16,262,275	(6,646,826)	54,667,846
Monterey Wastewater	-	-	-	-	303,913	303,913
Sacramento	7,298,391	10,676,884	14,964,630	20,071,493	21,285,386	74,296,785
Total	23,572,647	39,654,994	40,892,283	41,404,896	28,060,283	173,585,104

Source: Annual district amounts obtained from response to OC-33

California American Water Company
Dividend Pay-Out Percentage

	2002	2003	2004	2005	2006	2007	Cumulative
Current Year Dividends Paid	3,135,000	2,223,000	2,712,000	124,000	-	1,295,000	9,489,000
Current Year Net Income	2,990,000	5,037,000	2,287,000	(2,948,000)	1,300,000	467,000	9,133,000
Calculated Dividend Pay-Out Percentage	104.85%	44.13%	118.58%	-4.21%	0.00%	277.30%	103.90%
Current Year Dividends Paid		2,223,000	2,712,000	124,000	-	1,295,000	6,354,000
Prior Year Net Income		2,990,000	5,037,000	2,287,000	(2,948,000)	1,300,000	8,666,000
Calculated Dividend Pay-Out Percentage		74.35%	53.84%	5.42%	0.00%	99.62%	73.32%

Source: OC-41 (Statement of Cash Flows)
Note: Per response to OC-41, the target dividend is 75% of net income (based on the 12-month period ending September 30).

California American Water Company
Total Company (USGAAP)

	2003	2004	2005	2006	2007
Operating Revenues:					
Water	$ 97,898,064	$ 105,940,003	$ 105,033,354	$ 111,951,155	$ 120,249,411
Sewer	707,729	1,057,829	1,349,671	1,503,249	1,497,278
Other	918,999	(918,171)	4,878,976	1,248,823	2,609,553
Management	-	-	-	-	-
Total Operating Revenues	99,524,792	106,079,661	111,262,001	114,703,227	124,356,242
Operations & Maintenance Expense:					
Labor	10,589,142	10,760,963	11,671,181	12,137,754	14,098,643
Purchased Water	21,605,540	23,510,403	26,509,958	25,071,352	28,968,935
Fuel & Power	7,431,125	7,165,316	6,616,676	7,126,701	7,099,617
Chemicals	512,963	601,823	879,088	981,409	1,035,911
Waste Disposal	105,360	117,721	112,259	196,473	122,983
Management Fees	7,494,011	10,766,933	10,992,827	12,684,501	13,474,583
Group Insurance	2,278,341	2,327,026	2,634,070	2,646,494	2,632,620
Pensions	580,607	296,440	553,702	1,639,979	1,485,299
Regulatory Expense	1,448,085	1,875,379	3,880,168	2,807,756	2,718,457
Insurance Other Than Group	2,413,041	2,370,882	1,551,546	1,591,407	1,850,367
Customer Accounting	1,202,537	1,036,228	1,179,627	1,490,587	1,690,133
Rents	941,414	965,869	977,591	1,053,652	1,137,661
General Office Expense	816,371	971,367	1,717,503	1,337,970	1,309,152
Miscellaneous	7,141,874	7,239,503	14,067,436	8,828,366	8,378,523
Other Maintenance	2,813,869	2,853,871	5,519,485	5,723,614	7,010,145
Total Operations & Maintenance Exp	67,374,280	72,859,724	88,863,117	85,318,015	93,013,029
Depreciation	12,155,971	13,723,178	12,878,721	12,741,664	12,995,245
Amortization	554,787	1,275,715	343,666	881,091	335,667
General Taxes	3,667,976	3,982,197	4,018,651	4,300,432	4,653,621
State Income Taxes	517,067	393,204	(271,755)	(260,856)	(2,457,146)
Federal Income Taxes	1,878,116	1,211,398	(2,437,605)	(174,096)	(7,166,115)
Tax Savings Acquisition Adjustment	7,560	7,560	-	-	-
Total Operating Expenses	86,155,757	93,452,976	103,394,795	102,806,250	101,374,301
Utility Operating Income	13,369,035	12,626,685	7,867,206	11,896,977	22,981,941
Other Income & Deductions					
Non-Operating Rental Income	162,368	119,925	172,740	202,713	244,073
Dividend Income - Common	-	-	-	-	-
Dividend Income - Preferred	-	-	-	-	-
Interest Income	175,933	117,609	364,570	251,790	1,947,363
AFUDC Equity	228,989	101,453	-	295,885	-
M&J Miscellaneous Income	1,522,131	138,391	696,012	8,788	(125,288)
Gain (Loss) on Disposition	2,123,991	1,644,988	416,871	369,479	-
Total Other Income	4,213,412	2,122,366	1,650,193	1,128,655	2,066,148
Miscellaneous Amortization	159,376	122,331	32,408	13,708	13,708
Tax Savings Acqusition Adjustment	(7,560)	(7,560)	-	-	-
Misc Other Deductions	191,768	343,027	890,625	(1,739,677)	258,130
General Taxes	7,830	-	-	-	-
State Income Taxes	318,409	121,519	93,365	233,732	2,444,576
Federal Income Taxes	840,875	481,127	369,656	925,409	6,973,622
Total Other Deductions	1,510,698	1,060,444	1,386,054	(566,828)	9,690,036
Total Other Income	2,702,714	1,061,922	264,139	1,695,483	(7,623,888)
Income Before Interest Charges	16,071,749	13,688,607	8,131,345	13,592,460	15,358,053
Interest Charges:					
Interest on Long-Term Debt	11,144,696	10,228,946	10,225,230	10,379,147	12,814,321
Amortization and Debt Expense	83,276	59,142	59,734	94,619	78,106
Interest - Short Term Bank Debt	30,810	3,732	595,690	1,597,206	1,625,398
Other Interest Expense	(10,752)	15,358	210,817	310,042	368,433
AFUDC - Debt	(212,889)	57,707	(12,613)	(87,482)	4,987
Total Interest Charges	11,035,141	10,364,885	11,078,858	12,293,532	14,891,245
NET INCOME	$ 5,036,608	$ 3,323,722	$ (2,947,513)	$ 1,298,928	$ 466,808

Source: OC-36

7. Rate Case Expense

CalAm's requested rate case expense is separate from the General Office revenue requirement, and discussed by DRA in its testimony of August 21, 2008. Overland Consulting provides additional analysis of rate case expense in this chapter. Rate case expense includes CalAm's request to recover the expenses associated with the General Office and district-level filings in the current General Rate Case (GRC) cycle.

CalAm estimates it will incur $3,197,747 of costs to prepare, file, and prosecute these present rate case applications. A portion of this total is "applicable to California American Water's other districts." The company proposes to defer these particular costs ($460,720) until such time as these districts file their rate cases.[1] The remainder, $2,737,028, is the amount CalAm proposes to recover for its Monterey and General Office rate filing. CalAm proposes to amortize the costs over a 3-year period, resulting in an annual amortization of $912,343.

Overland calculated several key metrics concerning rate case expense that are summarized in Table 7-1.

Included in this analysis are two recent California proceedings, the Los Angeles rate case (A.06-01-005) and the Coronado, Village, Sacramento, and Larkfield rate cases (A.07-01-036). According to the company, it has incurred to date $1,065,027 and $1,165,821, respectively, on these two cases.[2]

Ta e 7 1
Ca fo a A e a a e
Ra e Ca e E e e Me f o Re e g

Description	No. of Cases w/ Available Info (A)	Average	Weighted Average	Median	Average Excluding Largest Customer Bases (B)
Rate Case Expense Requested per Customer	33 (27)	$11.20	$4.10	$7.59	$13.11
Rate Case Expense Approved per Customer	20 (16)	$9.39	$3.43	$6.15	$11.22
Rate Case Expense Requested as a % of Revenue	31 (26)	1.73%	0.65%	1.15%	1.97%
Rate Case Expense Approved as a % of Revenue	20 (16)	1.54%	0.54%	1.23%	1.83%

Sources: Derived from responses to OC-105 and OC-121.

(A) The first number presented in this column is the total number of cases used to calculate the Average, Weighted Average, and Median. The second number in parentheses is the total number of cases used to calculate the Average Excluding Largest Customer Bases.

(B) Customer bases in excess of 280,000 customers were excluded.

[1] Supplemental Direct Testimony of David P. Stephenson, p. 1.

[2] Responses to OC-54 and OC-57. CalAm cut off its analysis as of October 2007. Additional costs may have been incurred subsequently.

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Based on a conservative application of the average of each of these metrics (excluding the cases with customer bases over 280,000) to CalAm's request for the Monterey proceeding, it becomes clear that the company's request of $2,737,028 is excessive:

Ta e
Ca fo aA e a ae
Ra e Ca e E e e A e a e

Description	Average	CalAm Monterey Customers	CalAm Revenues Requested	Calculated Rate Case Expense
Rate Case Expense Requested per Customer	$13.11	42,308	N.A.	$554,658
Rate Case Expense Approved per Customer	$11.22	42,308	N.A.	$474,696
Rate Case Expense Requested as a % of Revenue	1.97%	N.A.	$58,551,000	$1,153,455
Rate Case Expense Approved as a % of Revenue	1.83%	N.A.	$58,551,000	$1,071,483

Note 1: The number of CalAm customers includes the Monterey and Monterey Wastewater districts (40,060 + 2,248) obtained from the response to OC-90).

Note 2: The CalAm revenues requested includes the cumulative amounts requested for Monterey and Monterey Wastewater districts ($55,501,000 + $3,050,000).

To put matters in perspective, CalAm has included nearly $1 million of legal fees in its current request (including the pro-rated costs associated with the cost of capital proceeding). Although legal fees are only a portion (35%) of the entire request in this case, they are nearly equivalent to the total costs incurred for each of the two California cases mentioned previously.

Employee Costs Assigned to Rate Case Expense

$298,768 of the total rate case expense of $2,737,028 requested by the company is associated with labor and related employee costs (e.g., travel). These employees work in the Cal Corp, LSC, and NSC organizations.

Because the rate case expense estimate for these costs was based on the number of hours multiplied by an hourly rate, Overland was able to determine what percentage of time CalAm had assumed each employee was going to spend on the rate case over a one-year period. The following table summarizes this information assuming a 2,080-hour year for the Cal Corp and LSC employees:

Chapter 7

Ta e 3 Ca fo a A e a a e Ra e Ca e E e e a a U e g Co a Co a o of "Co a a o " Co o e		
Employee	Total Hours	% of Year
Jordan	281	13.5%
Fulter	799	38.4%
Chew	642	30.9%
Halterman (A)	569	27.4%
Pressey	781	37.5%
Pilz	1,224	58.8%
Patacsil	201	9.7%
McCaleb	442	21.3%

Source: Response to OC-54.

Note: Includes the hours attributed to the cost of capital proceeding.

(A) Identified in OC-54 as "Suzette". Based on the other employees identified, it was determined that this was likely Suzette Halterman.

With the exception of Jordan, all of these employees are included in Cal Corp's charges to CalAm that are part of the General Office costs. Jordan is included in the LSC allocations to CalAm. According to CalAm's filing, Cal Corp labor costs are assigned to one of two categories – O&M (operating expense) or Capital Projects / Rate Cases.[3] A review of the support for the allocations between the two categories reveals the following:

Ta e 4 Ca fo a A e a a e Se e e Ca Co E o ee A o a o		
Employee	Operating Exp	Capital Exp / Rate Case
Jordan	10.0%	90.0%
Fulter	90.0%	10.0%
Chew	90.0%	10.0%
Halterman	90.0%	10.0%
Pressey	80.0%	20.0%
Pilz	0.0%	100.0%
Patacsil	89.0%	11.0%
McCaleb	80.0%	20.0%

Source: Derived from responses to OC-141, OC-142 and OC-166 and Workpapers GO-124 and GO-125.

[3] CalAm Rate Filing, Exhibit B - Chapter 6 - Section 1 - Table 1C.

Chapter 7

When the information from these two tables is combined, it suggests that the time (and associated labor costs) of some Cal Corp employees was included more than once in CalAm's rate application. None of these salaried employees should have more than 100% of their time assigned.

Ta e 5 Ca fo a A e a ae Se e e Ca Co E o ee A o a o			
Employee	Rate Case Expense	Operating Expense	Total
Jordan	13.5%	10.0%	23.5%
Fulter	38.4%	90.0%	128.4%
Chew	30.9%	90.0%	120.9%
Halterman (A)	27.4%	90.0%	117.4%
Pressey	37.5%	80.0%	117.5%
Pilz	58.8%	0.0%	58.8%
Patacsil	9.7%	89.0%	98.7%
McCaleb	21.3%	80.0%	101.3%
Source: Two previous tables.			

It is possible that these employees may work on rate cases in other jurisdictions.[4] If that is the case, the preceding calculations understate the amount that may be captured more than once in company's current California rate filing and filings in other jurisdictions.

CalAm also identifies a group of Rate Department personnel from the National Service Company whose labor costs are included in deferred rate case expense. One of the employees, Rod Nevirauskas, works in a department (Business Unit 32505) which attributes none of its time to rate cases or any other non-management fee category. Even though management has budgeted an allocation of <u>all</u> of Mr. Nevirauskas' time to various jurisdictions, it believes that it is appropriate to charge another 405 hours to deferred rate case expense in California. Just as with the four Cal Corp employees, his labor costs ($48,309) are being requested more than once in CalAm's rate application.

In its analysis of the Cal Corp charges to CalAm, Overland has proposed an adjustment to correct the company's request for over-recovery of labor costs of its operating expenses. While the same could have been done for the National Service Company employee, Overland chose not to propose an adjustment because the resulting effect on allocations to CalAm would have been relatively insignificant. However, the company's decision to include this redundant cost lends

[4] According to CalAm, only one employee at the LSC currently spends a significant amount of time on other rate cases. In the past, other employees did also (response to OC-215). This is CalAm's explanation for its witness' statement that "direct charges to a case is the most reasonable approach, particularly when we process cases for more than one state." (Supplemental Direct Testimony of David P. Stephenson, p. 7)

credence to the Overland's finding that rate case expenses requested by the company were excessive.

Conclusion

Our analysis of CalAm's regulatory expense demonstrate that CalAm's rate case expense exceeds every one of the alternative (based on American Water filings in other jurisdictions) calculated by Overland – in some cases by over 150 percent. It is our understanding that DRA has also evaluated rate case expense and made a recommendation concerning cost recovery. Our analysis indicates that CalAm's rate case expense is excessive. We defer to DRA concerning a cost recovery recommendation.

8. District Allocation of the General Office Revenue Requirement

In the prior rate case CalAm used a customer-based allocator to distribute its National Service Company and Local Service Company expenses to the district level. In this rate filing CalAm has proposed a "four-factor" allocator based on operations and maintenance expense, plant, payroll and "connections" (an analog for customers). In direct testimony CalAm described the factors included in the four-factor allocator as "those most common cost components and cost drivers of the operating districts."[1] For the reasons below, we recommend General Office costs be allocated to California districts using a customer-based allocation, as was done in the last General Office rate filing, to distribute CalAm's General Office cost among district operations.

There is nothing unusual about a four-factor allocator. However, it is important to define what the allocator represents. Contrary to what CalAm's testimony implies, increases or decreases in Monterey O&M, plant and payroll do not "drive" equivalent changes in AW's common (allocable) service company costs.[2] The four-factor allocator is an "unattributable" allocator. Unattributable allocators distribute joint costs (costs that exist because the corporate entity exists and that cannot be assigned based on causation) using one or more measures of size. We believe CalAm's four-factor allocator is inferior to a simple customer-based allocator, which is already being used by American Water (AW) to distribute the national and some of the regional General Office costs to the state level.

Recommended District Allocation of General Office Expense

Of the asserted "cost drivers" in CalAm's four-factor allocator, the three financial components (payroll, O&M and plant) are themselves related to, and ultimately exist because of, the fourth component (customers, or connections). Although most General Office costs do not vary directly with changes in customers, at a more fundamental level *all* costs (payroll, O&M, plant, etc.) at every level (district, regional and corporate) are incurred because of customers, without which *no* costs would be incurred.

AW uses customers to allocate a majority of regulated General Office costs, including all regulated NSC costs, from the service companies to California. In requesting a four-factor method to allocate this expense to the districts, CalAm is proposing that the Commission approve one allocator (customers) to move service company costs to the California state border, and a different allocator (four-factor) to further distribute the *same* costs within the state, based on an argument that corporate and regional costs are "driven by" plant, O&M and payroll, as well as by customers. If allocable service company costs were "driven by" district-level plant, payroll and O&M, any such link between the costs and their "drivers" would be dissolved, prior to district allocation, by the customer-based allocator used to distribute them to the state level.

Overland does not believe it makes sense to distribute costs geographically to the state border using a customer-based allocator and further distribute costs to the district level using a different

[1] Testimony of Gary Paquette, p.6, lines 10-12.

[2] When Monterey causes the New Jersey-based NSC to incur a specific costs, it is (or should be) directly charged to CalAm.

allocator. CalAm was correct to use customers to allocate General Office expense to the state *and* district levels in the prior rate case, and we recommend the Commission require CalAm to use the same customer-based method for the complete (state and district) allocation in this rate filing. Our recommended district allocation factors, based on year-ending 2007 customer levels without the Felton district, are summarized below.

Ta e 8 1
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District	Customers	Allocation Pct.
Coronado	20,791	12.22%
Los Angeles (1)	27,733	16.30%
Village	21,012	12.35%
Monterey Water (2)	40,060	23.55%
Monterey Wastewater	2,248	1.32%
Felton (2)	-	0.00%
Sacramento	55,917	32.88%
Larkfield	2,353	1.38%
To a	1 0 114	100.00

Source: OC-90

(1) OC-90 data does not show customers for Los Angeles. OC-90 shows customers for Baldwin Hills, Duarte & San Marion. Based on an analysis of district numbers in OC-90, these "055" districts were assumed to combine to be equivalent to Los Angeles as shown by CalAm in its rate filing.

(2) OC-90 does not show customers for Toro, Bishop, Chualar, Ralph Lane or Ambler Park. It was assumed that these combined in OC-90 under the category Monterey.

(3) 1,330 Felton customers as of 12/31/07 are removed on a pro-forma basis because of CalAm's plans to sell before the test year.

Overland's Recommended District-Level General Office Revenue Requirement

Using customer-based factors as shown above, Overland's recommended General Office revenue requirement compares with CalAm's and spreads to district operations as follows.

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CalAm District	Per CalAm Pcts	Per CalAm Amount	Per Overland Pcts	Per Overland Amount	Overland Adjustment to CalAm
Coronado	10.80%	1,835,857	12.22%	1,633,384	(202,472)
Los Angeles (1)	13.54%	2,301,621	16.30%	2,178,737	(122,884)
Village	13.39%	2,276,123	12.35%	1,650,761	(625,362)
Monterey Water (2)	31.81%	5,407,279	23.55%	3,147,807	(2,259,471)
Monterey Wastewater	2.28%	387,570	1.32%	176,438	(211,132)
Felton (2)	1.54%	261,780	0.00%	-	(261,780)
Sacramento	24.75%	4,207,172	32.88%	4,394,900	187,728
Larkfield	1.89%	321,275	1.38%	184,457	(136,817)
To a	100.00	16 998 6 5	100.00	13 366 485	3 63 190

Sources: Customer Allocation Factors, Table 8-1, Total 2008 & 2009 Revenue Requirements, Table 1-1

APPEN A

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BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for its General Office

QUALIFICATIONS OF HOWARD E. LUBOW

Q. Please state your name, your business address, and your position with Overland Consulting ("Overland").

A. My name is Howard E. Lubow. My business address is 10801 Mastin Street, Suite 420, Overland Park, Kansas. I am President of Overland Consulting. A current resume is provided with this testimony.

Q. What was the scope of your review in these proceedings?

A. Overland was retained by DRA to perform an audit review of the CalAm GO filing, pursuant to the Commission's Order in D.06-11-050. The scope of this review focuses largely on the cost allocation process among affiliates and between regulated and unregulated businesses. Our review also included major elements of the GO cost of service, as well as the analysis of CalAm synergies associated with the acquisition of the water properties in California formerly owned by Citizens Utilities. Finally, we reviewed CalAm and American Water compliance with the conditions imposed by the Commission in previous proceedings involving the approval of RWE acquisition of American Water and CalAm; and the subsequent authorization to transfer control back to American Water through public offerings.

Q. What is the purpose of your testimony?

A. I am responsible for the development of Chapter Six of the Overland Report.

Q. Does this conclude your testimony?

A. Yes.

HOWARD E. LUBOW
President

General

Mr. Lubow is President of Overland Consulting. He has more than thirty years of experience as a public utility consultant. His consulting engagements have encompassed a broad spectrum of management, finance and regulatory issues for electric, gas, water, pipeline, and telephone utilities. Recent project experience includes focused management audits, analysis of utility diversification and acquisition plans, prudence studies, accounting systems design, cost of service determination and allocation, utility property valuation, rate of return determinations and rate design issues. Mr. Lubow has testified in more than 100 regulatory and civil litigation proceedings and has testified in approximately 20 jurisdictions throughout the country.

Education

- Bachelor of Business Administration - Accounting, 1968, University of Missouri - Kansas City. Minor in economics.
- Graduate studies in quantitative and systems analysis, 1968-1970, University of Missouri - Kansas City.

Representative Experience

Electric and Gas

- Project Manager in the review of long-term financial projections prepared by Midland Cogeneration Venture Limited Partnership to be used in regulatory proceedings concerning proposed modifications to a power purchase agreement. The engagement included the sensitivity testing of major variables in the partnership's financial model.
- Project Manager in the review of accounting and finance issues raised by Connecticut utilities in connection with proceedings on long-term capacity measures. Addressed the implications of new generation facilities and DSM projects on regulated electric utilities.
- Project Director for a multi-disciplinary consulting team that reviewed the proposed Exelon / PSEG merger on behalf of the New Jersey Board of Public Utilities. Also the primary expert witness in areas of: finance and regulatory policy, responsible for analysis of the merger's financial impacts, in particular the impact on PSE&G, the New Jersey utility. Responsible for recommendations to insure that if the merger is approved, that the transaction price, terms and conditions are fair and reasonable in light of applicable standards for review, and that the New Jersey utility remains financially secure.
- Performed a financial and market feasibility study of a fiber optic network designed to provide SCADA requirements for a large multi-state electric utility

interested in selling capacity to telecommunications carriers and high volume customers.

- Sponsored the overall development of utility revenue requirements, jurisdictional and class cost of service studies and rate design issues in numerous electric, gas, water and telecommunication cases throughout the country.

- Conducted an analysis of the adequacy of depreciation rates for a large independent telephone company located in Texas in order to assess the relationship of capital recovery in light of technological obsolescence.

- Directed and developed a two day training seminar for the Kentucky Public Service Commission addressing energy and telecommunications issues raised in rate filings, and utility planning and forecast models required in considering the use of projected test year data.

- Supervised and directed a group of PSC Staff members in the review of a rate filing relying upon the use of a projected test year.

- Directed a comprehensive financial and regulatory base period audit of a large gas transmission and distribution company in connection with implementation of an incentive regulation plan. Reviewed savings resulting from force reductions of 1,200 employees and implementation of aggressive cost reduction programs.

- Performed a study of an LDC's gas supply and transportation procurement practices in a post Order 636 operating environment, where the LDC's transportation and supply services continued to be provided by affiliated companies. The parent reorganized its pipeline transmission and gas supply services into a separate company, transferring jurisdiction from state regulators to the FERC. Developed a model to quantify an optimal supply and transportation mix for state ratemaking purposes.

- Performed a review of intrastate pipeline issues including the use of a straight fixed-variable cost methodology; regulatory treatment of stranded costs; pipeline competition issues; and the merits of a corporate restructuring and related effects on cost of service and changes in corporate operations.

- Developed a revenue requirement analysis of an intrastate gas transmission pipeline company addressing issues including: proper recognition of net operating loss carryforwards for ratemaking purposes; treatment of deferred start-up costs; application of criteria for consideration of acquisition premium in rates; and the recognition and relationship of financial criteria in the ratesetting process.

- Directed a comprehensive review of the $850 million PG&E gas transmission pipeline expansion project. This study included a review of regulatory considerations in recognizing construction and operating costs in light of competition in the California pipeline markets, and based upon the Commission intended allocation of risks among regulated customers, project shippers and the pipeline owner.

- Directed a review of gas procurement policies and procedures, and addressed the impact of FERC Order 636 for three Wyoming LDC's. This study addressed the relationship of gas pipeline and LDC affiliate organizations associated with the gas supply and transportation functions, and the impact of the affiliated organizational structures on gas prices measured against other utilities in the region.

- Reviewed impacts of FERC Order 636 on gas utility distribution companies including staffing and other operating requirements, changes in gas procurement and storage policies, and effects on marketing plans. Also reviewed various pipeline compliance filings, analyzing impacts on firm and non-firm customers.

- Reviewed electric and gas utility fuel procurement policies and procedures, organization and internal controls in various engagements. Developed recommendations resulting in significant benefits to utilities under review.

- Performed fuel audit investigations in several jurisdictions addressing such issues as economic dispatch procedures, fuel acquisition policies, affiliated mine or pipeline operations, captive mine development and compliance with Commission rules and regulations. These studies included the review of prices and returns produced from affiliated operations vs. third-party options and market prices available.

- Reviewed gas supply issues including procurement policies, supply mix, affiliate transactions, and contract provisions in the context of both cost of service and management review proceedings. Provided policy analysis regarding considerations and benefits of increased gas supply and pipeline competition.

- Participated in three FERC interstate pipeline rate proceedings addressing cost of service issues, including appropriate classification and allocation methodologies. Also addressed construction costs, overhead, and pipeline operations issues in a major oil pipeline docket.

- Performed a detailed analysis and presented testimony regarding the relative economic benefits of the operation of a LNG plant vs. meeting seasonal peak demands through pipeline contract commitments.

- Developed gas transportation pricing criteria and implementation guidelines in the development of tariff service offerings for several gas LDC's.

- Developed numerous gas cost service studies, and related rate design recommendations for local distribution companies, as well as pipeline suppliers. Testimony regarding such studies was presented before various state commissions, as well as the FERC.

- Responsible for gas distribution company revenue requirements in over twenty-five cases, addressing accounting, cost allocation, operations, and rate design issues. These cases generally included an analysis of gas production, gathering, and transmission systems owned by the LDC parent.

- Developed a damages model for a gas utility in civil litigation arising from acquisition of a defective distribution system caused by improper installation practices. Measured incremental construction and operating costs associated with pipe replacement program.

- Developed a risk analysis model used to associate the relationship between cost recovery and changes in class consumption patterns for a gas distribution company.

- Developed a quantitative model to estimate jurisdictional and class-peak consumption for distribution gas companies.

- Performed an overview of regulatory considerations in the oversight of holding company formations and operations. This project was conducted on behalf of a PUC to analyze issues associated with holding company formations, utility diversification, and affiliated interest oversight and controls. The four largest electric utilities in the state were included in the study. The final report covered policy issues, as well as more detailed discussions of monitoring procedures and recommended filing requirements.

- Developed diversification guidelines for utilities in several jurisdictions. Addressed regulatory concerns and limits that might be implemented to control contingent adverse consequences to utility ratepayers.

- Performed an overview of regulatory considerations in the oversight of holding company formations and operations. This study addressed appropriate regulatory guidelines and oversight policies for utility and nonutility operations.

- Directed reviews of two major utility subsidiary gas intrastate pipeline systems, addressing cost of service, operating issues, and appropriate accounting for overheads and affiliated transactions from regulated electric utility parent companies.

- Developed a financing plan and reorganization of corporate structure for an electric utility having gas properties and a separate gas subsidiary. This project included preparation of SEC U-1 filings, filings with regulatory agencies and testimony to address the impact of the proposed financing and reorganization on cost of capital and rates.

- Responsible for the independent analysis of the feasibility and economics of consolidation of two major electric utilities. The project focused primarily on the quantification of merger benefits associated with consolidated operations. This in-depth twelve-month study also included a detailed review of the scope of services and basis of pricing such services among affiliates. The study addressed a number of affiliate interest issues including: the basis of pricing and level of capacity and/or energy supplied by affiliate vs. third-parties; the services provided by an affiliate "service" company vs. internal resources or purchases from third-parties; and the consideration of management resources devoted to non-utility functions and the basis of compensation for such resource transfers.

- Reviewed American Electric Power System Agreement to assess the reasonableness of fuel and purchased power costs incurred and allocated to its utility operating companies. The analysis also considered system dispatch and related fuel accounting issues associated with energy requirements of regulated customers versus wholesale transactions.

- Responsible for the development and implementation of phase-in plans utilized to defer initial costs of new generation facilities. Developed assessment criteria and related models to assign capacity from new plant additions between jurisdictional and nonregulated service.

- Developed and conducted a training program on the measurement of relative and absolute fuel productivity measures in ranking utility's effectiveness in fuel procurement and generation system operations.

- Developed a framework for implementation of competitive pricing for an electric utility facing higher costs due to nuclear plant additions. The analysis also encompassed an incentive rate program designed to induce greater use of excess capacity, as well as to improve the utility load factor.

- Analyzed and implemented economic dispatch models used to evaluate the effects of changes in generation capacity and fuel use.

- Conducted several comprehensive nuclear management and prudence reviews addressing construction, management, planning and economics issues.

- Directed a two-year study of the impacts on and options available to an electric utility due to the abandonment of a nuclear plant near completion. Presented a workout plan to regulators. Study involved a five-year forecast of financial results including construction expenditures and operating costs.

- Developed commercial operation date criteria and guidelines for nuclear power plants, which were supported by a national industry survey.

- Developed a financial analysis of a major municipal utility facing an extended outage of its nuclear power plant, with alternative pricing strategies, recognizing competitor pricing in adjacent service areas. Developed multi-year cost of service and revenue requirements models, and presented results to the Utility Board.

- Responsible for the development of budget and forecast models for a major municipal water utility in the Midwest.

- Performed studies for municipalities to determine the feasibility of acquiring street lighting facilities, or in the alternative, pricing options other than PSC regulated tariffs.

- Conducted an industry survey of the effectiveness and relative benefits achieved from the use of uniform filing requirements in utility rate applications. The findings were published and distributed to the utility industry and regulatory commissions.

- Developed class cost-of-service studies including identification of direct assignments and review of distribution facilities, methodologies and criteria for the allocation of generation and bulk power facilities, and risk differentials associated with various classes of service.

- Project director of a review of Kentucky current statutes, regulations and policies governing integrated resource planning. The project addresses recommendations necessary to mitigate impediments to the development of appropriate demand-side management programs, energy efficiency, renewables, and new generation technology options available within the state.

- Project manager of a regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions.

Valuation

- Conducted a feasibility study regarding the sale of a utility power plant used to provide steam heat and process steam to commercial customers through a downtown area distribution system. The feasibility study addressed energy alternatives and pricing options; cogeneration; and a financial and operating forecast assuming alternative case scenarios based upon various potential ownership structures.

- Performed a valuation analysis on behalf of an investor group for the construction and operation of a high capacity fiber network between Seattle and Vancouver, designed to serve large commercial companies and telecommunications providers. Provided due diligence analysis of market demand and pricing assumptions, competition, and anticipated construction and operation costs.

- Performed a valuation analysis of an electric utility on the southwest on behalf of a private investor group interested in making a tender offer for the shareholder interests of this public company. Also participated in presentations to investment bankers and commercial banks who were to fund the acquisition.

- Performed a valuation study regarding two natural gas distribution affiliates in the Midwest, whose electric utility parent was seeking offers for a sale of the assts and related securities. Developed analysis of the impact of regulation on property values.

- Performed a valuation analysis of a gas transmission company used to evaluate offers for the company. Developed due diligence and information materials provided to interested parties. Participated in presentations to interested parties with investment bankers.

- Developed a valuation analysis used in litigation proceedings to support the reasonableness of the acquisition price for a rural electric company acquired by an investor owned electric utility company.

- Developed and applied a model for the determination of the value of helium extracted from natural gas relied upon in litigation cases in federal courts in Oklahoma and Kansas. Analysis required the determination of extraction costs at plants involving four major pipeline systems in the Midwest. Developed studies of construction and operating costs associated with helium extraction plants, as well as the analysis of incremental costs and revenues related in by-product liquid extractions.

- Performed an analysis of the value of long-term gas transportation contracts relied upon in civil litigation and by regulators. The studies included the development of construction cost and operations estimates, as well as discount rates to be employed.

- Performed a reproduction cost study for a cable television company located in the west. As part of the project, developed a continuing property records system. Company used results in the negotiation of the sale of its assets.

- Represented a member of a consortium formed to build a satellite network for cellular services with commercial applications throughout the United States. Developed a valuation analysis and business plan used in a private placement for equity financing. Acted as a co-investment advisor with a large Wall Street firm in providing these services and making presentations to potential investors.

- Developed a valuation analysis of nuclear facilities, which included a detailed study of assets, and their costs, required for environmental protection as defined by state statutes and federal regulations. The study was relied upon in determining the proper classification and valuation of nuclear assets for property tax purposes.

- On behalf of a state department of revenue, developed a review of property tax rules and definitions as applied to telephone, cellular and cable companies. The study included a national survey of valuation practices relied upon by each state department of revenue.

- Developed appraisals of telecommunications properties for property tax purposes using standard valuation methods. Presented studies in administrative and civil proceedings. Developed cost of capital analysis based upon applications of the DCF and CAPM models.

- Developed appraisals relied upon in property tax cases involving telecommunications properties where subject sales were involved within two years of the date of property assessment.

- Prepared appraisals for a natural gas transmission company in appeals of property tax assessments in administrative proceedings in Kansas and Oklahoma.

- Prepared appraisals of two investor owned utilities on behalf of the Iowa Department of Revenue. The appraisals included a subject sale analysis, and a review of economic obsolescence.

- Developed appraisals of two Class I railroad companies in contested property tax valuation in civil proceedings in New York. Valuation studies included the review of the cost method based on RCNLD.

- Assisted an electric G&T coop in valuation and due diligence analysis of electric and gas properties offered for sale by a large independent telephone company.

- Developed a manual for "Alternative Valuation Procedures" on behalf of the Virginia State Corporation Commission – Public Service Taxation Division in a state that otherwise relies on the cost method.

- Developed a business plan and other financial advisory services to the National Homebuilders Association joint venture subsidiary – "Smarthouse"; in connection with securities offerings.

- Developed a complete appraisal of a cogeneration facility on behalf of the Virginia State Corporation Commission, Public Service Taxation Division. The study included "Subject Sale" and "Comparable Company" analyses, as well as a review of capacity and energy forecast prices in the PJM market area.

- Prepared a complete appraisal of CSX railroad operating property on behalf of the Florida Department of Revenue.

- Prepared a complete appraisal of Qwest Corporation on behalf of the Iowa Department of Revenue. The appraisals included "Subject Sale" and "Comparable Company" market analyses.

Telecommunications

- Developed and directed a three-day nationally attended conference entitled "Competitive Strategies in the Local Exchange Marketplace".

- Directed audits of RBOCs regarding compliance with regulatory accounting requirements; procedures to allocate costs between regulated and non-regulated activities; policies and rules for pricing transactions among affiliates; and monitoring reports filed with regulators.

- Conducted a review of depreciation rates for local exchange telecommunications property of the central division of a national carrier.

- Directed a comprehensive review of the operation of a RBOC telecommunications incentive plan, based upon a revenue sharing mechanism, over a three-year period. The study reviewed quality of service measures, capital expansion programs, work force reductions, and other major elements of operating expense for the review period. Provided policy options regarding modifications to the incentive plan for prospective consideration.

- Developed business plan and other related materials for telecommunications reseller in its initial public offering. Provided ongoing financial and regulatory services, including development of all SEC filings.
- Directed an analysis of switching and other LEC facilities required and costs of providing inter-exchange services to an alternative service provider in the Phoenix, Arizona area.

Publications and Presentations

- "The Use of Uniform Filing Requirements by State Regulatory Commissions - An Industry Survey," May 1980.
- "Regulatory and Accounting Implications of Phase-in Plans," NARUC Biennial Regulatory Information Conference, September 1984.
- "Rate Moderation Plan Considerations" Public Utilities Accounting and Ratemaking Conference, sponsored by the Texas Society of CPAs, April 1985.
- "Review of The Proposed Amendment to FASB Statement No. 71," Presentation to the Financial Accounting Standards Board, June 1986.
- "Regulatory Implications Associated with the Prudence Audit Process," NARUC Biennial Regulatory Information Conference, September 1986.
- "On the South Texas Project and Other Cases," The Advisory, March 4, 1987.
- "Regulatory Considerations Inherent in Assessing Utility Culpability" (Richard Ganulin coauthor), Public Utilities Fortnightly, 1987.
- "Framework for a Competitive Strategy," Southeastern Regional Public Utilities Conference, Atlanta, GA, September 1988.
- "Competitive Strategies in the Local Exchange Marketplace," a three-day telecommunications conference sponsored by Overland Consulting and the University of Missouri at Kansas City, September 1991.
- "Considerations Associated with the Review of Rate Applications Based Upon Projected Test Periods," a two-day training seminar conducted on behalf of the Kentucky Public Service Commission, December 1992.
- "Impact of Deregulation and Competition On Property Tax Valuation Within the Utility Industry," Western States Association of Tax Administrators, Austin, Texas, September 1995.
- "Appraisers Find Help in Recent Accounting Rules" (Gregory Oetting, coauthor), Fair & equitable, August 2003.

- "Blue Chip Method Overview", 21st Conference of Unit Value States; Memphis, Tennessee, October 2004.
- "The Yield Capitalization Method – Application Issues", WSATA Unitary Appraisal School, Advanced Class – Logan, Utah, January 2007.
- "Overview of FIN 46(R), SFAS No. 133, and SFAS No. 71," (Gregory Oetting, co-presenter), Connecticut Department of Public Utility Control, May 2007.
- "Accounting and Finance Issues Associated with Contracts for Differences-Generation/DSM Projects" (Gregory Oetting, co-presenter), Connecticut Department of Public Utility Control, September 2007.
- "Accounting Pronouncements Impacting Financial Reporting Associated with Utility Purchase Power Agreements", WSATA Unitary Appraisal School, Advanced Class, Logan, Utah, January 2008.
- "Rating Agencies – Current Methods Employed and Recognition of Imputed Debt", WSATA Unitary Appraisal School, Advanced Class, Logan, Utah, January 2008.

Consulting Work History and Industry Experience

1991 - Present: **Overland Consulting**

President. Responsible for administration and review of management auditing, regulatory consulting, and litigation support services. Provide expert witness services in projects involving decision analysis, damages assessment, ratemaking, valuation, and accounting.

1997 – 1999 **Kansas Pipeline Company**

Executive Vice-President; Chief Operating and Financial Officer. Responsible for the day-to-day operations of this natural gas pipeline, as well as direct responsibilities associated with the financial, accounting, and regulatory functions of the Company. Implemented a reengineering and downsizing program that resulted in a major reduction in operating expenses. Negotiated new gas supply and transportation contracts. Renegotiated credit lines on more favorable terms. Responsible for the negotiation and acquisition of a natural gas marketing company. Developed and implemented a management incentive program for senior executives. Developed due diligence and presentation materials relied upon by potential buyers of Kansas Pipeline assets.

1990 – 1991 **Amerifax, Inc. (Americonnect)**

Chief Executive Officer. Directed the IPO for this telecommunications switchless rebiller. The company implemented a national marketing program, focusing primarily in the Midwest. After five years, the company was acquired for approximately three times its IPO valuation.

1983 - 1991: **LMSL, Inc.**
President. Responsible for administration and review of regulatory services projects and research studies. Expert witness in regulatory proceedings. Director of special projects including management audits, financing feasibility studies, property acquisition and merger feasibility studies and development of innovative solutions to current regulatory issues.

1976 - 1982: **Drees Dunn Lubow & Company**
Managing Partner. Responsible for projects for utility clients. Responsibility included financial and managerial analysis of public utility companies and the presentation of expert testimony before regulatory commissions.

1972 - 1976: **Troupe, Kehoe, Whiteaker & Kent**
Senior Regulatory Consultant. Responsible for special services work for utility clients, including accounting systems design, cost of service determination and allocation, budgeting and rate designs. Performed fair value determinations, developed cost analysis studies, curtailment requirements analysis, and forecasts of utility operations.

1968 - 1972: **Kansas City Power & Light Company**
Senior Accountant. Analyzed accounting and reporting procedures, taxes and costs of operations. Assisted in the preparation of the Federal and State income tax returns and the Annual Report to stockholders. Assisted with rate filings in Kansas and Missouri. Developed tax basis property accounting system.

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for its General Office

QUALIFICATIONS OF ROBERT F. WELCHLIN

Q. Please state your name, your business address, and your position with Overland Consulting ("Overland").

A. My name is Robert F. Welchlin. My business address is 10801 Mastin Street, Suite 420, Overland Park, Kansas. I am a Senior Manager in Overland Consulting. A current resume is provided with this testimony.

Q. What was the scope of your review in these proceedings?

A. The scope of my responsibility included a regulatory audit of the service companies and allocations that contribute to CalAm's General Office revenue requirement, including the historical years 2006 and 2007, the budget year 2008 and the forecasted test year, 2009. Please see the testimony of Howard E. Lubow for a complete project scope description.

Q. What is the purpose of your testimony?

A. I am responsible for Chapters one through five and Chapters seven and eight of the Overland report.

Q. Does this conclude your testimony?

A. Yes.

ROBERT F. WELCHLIN, CPA
Senior Manager

General

Regulatory consultant to the telecommunications, cable, electric and gas industries. Manage operational, financial and regulatory audits, reviews of rate filings and cost studies in the energy utility, telecommunications and cable industries. 21 years of industry experience.

Education

- Master of Business Administration, St. Edwards University, 1986.
- Bachelor of Science, Accounting and Business Administration, Eastern Illinois University, 1979.

Representative Experience

Electric and Gas

- Exelon / PSEG Merger – Assisted the New Jersey Board of Public Utilities in review of the proposed merger of Exelon (Commonwealth Edison, Pennsylvania Energy) with PSEG (Public Service Electric & Gas). Responsible for the review of the impact of combining the two holding companies' service companies (the companies that provide managerial, technical and administrative services to associated companies) on the New Jersey genco and utility. (2005-2006)

- Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas Regulatory Audits – Project Manager for audits of the affiliate relationships and cost allocations of Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas conducted on behalf of the New Jersey Board of Public Utilities (BPU). The audits examined whether each Company maintained a strict separation of risks, functions, and assets between their regulated utilities and unregulated affiliates to comply with BPU Standards. The audits also documented each Company's cost allocation methodologies and results for a two-year period. (2002-2003)

- Sempra Energy – Project Manager for a review of the costs of Sempra Energy's holding company. The review, conducted on behalf of the Utility Consumer Action Network (UCAN) was a part of the review of Sempra Energy's rate application with the California Public Utilities Commission (A.02-12-027 and A.02-12-028). (2003) Performed a similar review in the subsequent rate applications of subsidiaries, San Diego Gas & Electric Company and Southern California Gas Company (A.06-12-009 and A.06-12-010). (2007)

- Kansas Pipeline Company - Directed the cost of service component of the initial FERC "Section 7" cost of service and base rate filing of Kansas Pipeline, which had been exempt from FERC rate regulation prior to 1997. Submitted and defended testimony on behalf of Kansas Pipeline before the FERC covering the overall cost of service filing, the historical basis for the calculation of acquisition premium and company's test year operations and maintenance expenses (1998 – 2000).

- Pacific Gas and Electric 1999 General Rate Case - Reviewed projected test year administrative and general expense levels and allocation of costs between the utility and affiliates. Submitted and defended testimony on behalf of the California Public Utilities Commission (1998).

- Pacific Gas and Electric Audit of Inter-Company Relationships and Transactions - Managed an audit of PG&E's compliance with regulatory requirements and internal control over relationships and transactions between the utility and its unregulated affiliates on behalf of the California Public Utilities Commission. (1998).

- Southern California Gas Performance Based Ratemaking (PBR) Filing - Conducted a review of 1994 and 1995 base margin costs. Submitted testimony on behalf of the California Public Utilities Commission. Issue areas included operations and maintenance expenses, corporate allocations, employee and executive compensation, post-retirement benefits, and savings from restructuring and force reduction programs (1996).

- Missouri Gas Energy Rate Case - Submitted cost of service testimony on behalf of Mid-Kansas Partnership and Riverside Pipeline, L.P. in connection with Missouri Gas Energy's base rate filing. Issues included deferred gas safety costs, merger-related savings and weather normalization (1996).

- Western Resources / Kansas Power and Light Rate Case - Conducted a rate case audit and submitted and defended cost of service testimony on jurisdictional cost allocations, operations and maintenance expenses and pension expenses on behalf of the Kansas Corporation Commission (1992).

- Montana Dakota Utilities and Mountain Fuels - Conducted focused management audits of the gas supply operations of two western local distribution utilities for the Wyoming PSC. Assessed the management and organization of each company as it related to gas supply, the degree to which supply options were optimized, the potential impact of FERC Order 636, and the relationships between the LDCs and their pipeline and production affiliates (1992).

- Big Rivers Electric Cooperative - Reviewed fuel receiving and inventory policies and coal contract terms in connection with a focused management audit of fuel procurement for the Kentucky PSC. (1993).

- Illinois Power Company (Illinova) - Performed internal operational audits of nuclear and fossil fuel procurement, natural gas procurement and delivery, various corporate, power plant and service area operations, and nuclear plant construction contracts. (1980 to 1983).

Telecommunications

- Frontier (Citizens) Telecommunications Regulatory Audit - Directed a California statutory regulatory audit of Citizens' California PUC financial reporting and shareable earnings. , including transactions between Citizens, its Connecticut-based parent company and its affiliates. (2004-2005).

- Pacific Bell Regulatory Audit – Directed a California statutory regulatory audit of Pacific Bell's California PUC financial reporting, including transactions between Pacific Bell, its parent company (SBC) and its affiliates and subsidiaries. (2001-2002).

- Roseville Telephone Regulatory Audit - Directed and conducted a regulatory audit of the company's compliance with affiliate and non-regulated activity transaction rules and reviewed the company's calculation of earnings shareable with customers under the California PUC's New Regulatory Framework rules. Submitted and defended testimony on the audit on behalf of the CPUC (1999- 2000) Performed a followup audit of 2001-2003 regulated earnings (2004).

- New York Telephone Loop Study - Directed a study of NYT's subscriber loop network. Coordinated the effort of a multi-disciplined team that included regulatory, network operations, engineering and data processing specialists. The major work products included an inventory of subscriber facilities, determination of facility utilization in different geographic regions, determination of the relative accuracy of the major databases containing network facility information, and verification of billing records with installed facilities (1991).

- AT&T Review of Affiliate Transactions - Conducted a review of the affiliate management and accounting relationships among the subsidiaries of AT&T. Documented significant transactions and allocations through the AT&T organization that affected AT&T Communications. Examined policies and procedures that affected the Communication subsidiary's decision to use internal sources of supply and the corporate entity's allocation of costs to subsidiaries (1990).

- Bay Area Teleport - Conducted a review of the impact of local exchange carrier price flexibility on competitive access in California (1988).

- GTE - Analyzed Indiana local exchange rates and developed a computer model to distribute the carrier's revenue requirement over a matrix of local services and rate groups (1989).

Cable

- Late Payment Costs - Analyzed costs imposed on cable systems by late-paying customers and prepared studies to quantify the additional costs of handling past due accounts. (1995 through 2001).

- Cost of Service - Analyzed cable system costs and prepared cost-of-service rate studies for several cable companies, including several of the nation's largest cable systems. Developed cost-of-service methodologies to properly account for affiliate relationships and corporate and divisional cost allocations to the cable systems. Analyzed incremental cost of service under FCC Form 1235 rules for a group of systems calculating the revenue requirement impact of upgrading system capacity upgrades (1994-1999).

- Franchise Issues - Developed financial models to determine the financial and potential rate impact of franchise requirements for system upgrades and rebuilds. In 1997, coordinated the financial aspects of a franchise proposal submitted by the Company by a California local franchise authority (1995 and 1997).

- Programming Costs - Developed a database application to calculate programming cost increases on a cable-system basis to comply with FCC requirements (1994).

Work History

1996 - Present: **Overland Consulting**
Senior Manager. Plan, supervise and perform telecommunications and energy industry consulting projects, including audits, on behalf of public utility commissions and other government agencies.

1993 - 1996: **KPMG Peat Marwick LLP**
Senior Manager. Information, Communications and Entertainment Line of Business. Developed and managed cable TV, and telecommunications and industry consulting engagements.

1987 - 1993: **LMSL, Inc., Overland Consulting**
Manager. Conducted audits of energy and telecommunications companies; sponsored testimony in regulatory proceedings. (LMSL is a predecessor firm of Overland Consulting).

1984 - 1986: **Public Utility Commission of Texas**
Senior Staff Accountant. Reviewed electric, telephone and water utility rate and regulatory filings and sponsored cost of service testimony in rate hearings.

1980 - 1983: **Illinois Power Company**
Senior Internal Auditor. Planned, directed and performed operational and financial audits of the company's headquarters departments, power stations and service offices. Prepared the annual department operating plan and drafted the report to the Audit Committee of the Board of Directors for approval by the Director of Internal Auditing. Coordinated work with external auditors.

Certifications

Illinois CPA Certificate No. 31763, University of Illinois, February 18, 1982.
Kansas CPA Certificate No. 9821
Kansas Practice Permit No. 3349
Member, American Institute of CPAs

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